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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

NOTICE OF FILING UNS GAS, INC.'S REJOINDER TESTIMONY

UNS Gas, Inc., through undersigned counsel, hereby files the Rejoinder Testimony of James S. Pignatelli, Kentton C. Grant, Dallas J. Dukes, Karen G. Kissinger, Gary A. Smith, D. Denise A. Smith and D. Bentley Erdwurm in the above-captioned docket.

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Arizona Corporation Commission
DOCKETED
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RESPECTFULLY SUBMITTED this 11th day of April 2007.

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UNS GAS, INC.

REJOINDER TESTIMONY

April 11, 2007

BEFORE THE ARIZONA CORPORATION COMMISSION

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Rejoinder Testimony of

James S. Pignatelli

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

I. Introduction 1

I. INTRODUCTION.

Q. Mr. Pignatelli, have you reviewed the Surrebuttal Testimony filed by the Commission Staff and Intervenors in this case?

A. Yes, I have.

Q. What is the purpose of your Rejoinder Testimony?

A. My Rejoinder Testimony responds

Q. Mr. Pignatelli, please address why the Company discussed the recent Chaparral decision in its Rebuttal Testimony?

A. Our discussion was intended as a placeholder as issues surrounding the decision unfold. The decision provides guidance on the determination and utilization of fair value rate base in rate cases before the Commission. I believe how the Commission reacts to the decision may have an impact on how rates will be set in all future cases before the Commission. Accordingly, the Company raised the decision in this case.

Q. Mr. Pignatelli, on page 1 of her Surrebuttal Testimony, Ms. Scheier criticizes the Company for "sending customers to predatory lenders to meet their payment obligations." Do you have any response?

A. While I understand Ms. Scheier's Surrebuttal Testimony is an attempt to clarify ACAA's concern, her allegation of the Company's "irresponsibility" continues to suggest that, due to the availability of pay day loan services at some locations, the Company is somehow encouraging customers to enter into such loan agreements in order to pay their UNS Gas bills. As discussed in the Rebuttal and Rejoinder Testimonies of Gary Smith, this is simply not the case. Customers could make the decision to enter into such agreements even if UNS Gas retained all of its branch offices and the customer needed cash to pay his or her

gas bill, or even if there were "ATM-like Kiosks" as Ms. Scheier suggests. The decision to close some branch offices and offer alternative locations for our cash paying customers was made in an effort to keep down costs for all of the Company's customers, including those low income customers for which Ms. Scheier testifies.

As for her confusion as to the treatment of additional fees, I am sorry that she was not aware of UNS Gas' practice in this regard. Again, UNS Gas pays any additional fee charged by payment locations as long as the customer does not have the option of paying at a nearby UNS Gas facility. The bill insert, provided in Mr. Smith's rebuttal testimony, that was sent to customers last year in anticipation of the lobby closures clearly outlined each location's payment options, including use of various cash-payment vendors and courtesy drop boxes for checks and money orders—both of which are available without a fee in these locations. Locations where lobbies remained open are listed on our website as having a fee apply when customers choose a cash agent instead of utilizing the customer lobby available to them.

Mr. Smith can provide additional information about the Company's payment options. UNS Gas strives to offer its customers as many payment options as possible, while at the same time, keeping down the costs that are ultimately paid by customers.

Q. Does this conclude your Rejoinder Testimony?

A. Yes.

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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

Rejoinder Testimony of

Kentton C. Grant

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

I. Introduction 1

II. Response to Staff Witness Ralph C. Smith 2

III. Response to Staff Witness David C. Parcell 10

IV. Response to RUCO Witness Marylee Diaz Cortez 14

V. Response to RUCO Witness William A. Rigsby 16

VI. Conclusion 24

Exhibits

Exhibit KCG-15 Growth Rates Experienced by Arizona Utilities
Exhibit KCG-16 Example of Construction Project Funding with Customer Advances
Exhibit KCG-17 Impact of CWIP and Customer Advances on Test Year Rate Base
Exhibit KCG-18 Moody's Special Comment dated June 2006

I. INTRODUCTION.

Q. Please state your name and address.

A. My name is Kentton C. Grant. My business address is One South Church Avenue, Tucson, Arizona, 85701.

Q. Are you the same Kentton C. Grant that filed Direct and Rebuttal Testimony in this case?

A. Yes.

Q. Have you reviewed the Surrebuttal Testimony filed by the Commission Staff and Intervenors in this case?

A. Yes, I have.

Q. Please provide your general response to the Surrebuttal Testimony filed by the Commission Staff and the Intervenors.

A. Most of the issues raised in my Rebuttal Testimony still remain open. The Staff rejects the Company's request to include construction work-in-progress ("CWIP") in rate base, and continues to insist that *all* customer advances be used to reduce rate base, even those advances related to the test year-end CWIP balance. Additionally, the position taken by Staff on what constitutes a reasonable rate of return ("ROR") on fair value rate base ("FVRB") is mathematically equivalent to the position previously taken by Staff, and as a result, is not responsive to the concerns expressed by the Arizona Court of Appeals in a ruling involving Chaparral City Water Company ("Chaparral"). The Commission Staff ("Staff") also continues to recommend an unreasonably low return on equity ("ROE") and the use of a capital structure that is more highly leveraged than is typical for gas distribution utilities.

With respect to the Surrebuttal Testimony filed by the Residential Utility Consumers Office ("RUCO"), it appears that the Company and RUCO are now in agreement on the appropriate cost of debt and capital structure for UNS Gas. However, similar to Staff, RUCO continues to recommend an unreasonably low ROE, the exclusion of CWIP from rate base, and the use of *all* customer advances to reduce rate base, even those advances related to the test year-end CWIP balance. These positions, when coupled with the other revenue requirement adjustments and rate design positions advocated by RUCO and Staff, will not provide UNS Gas with an opportunity to earn a reasonable ROR on its investment, will harm the Company's ability to attract capital on reasonable terms, and will hasten the filing of yet another costly rate case for UNS Gas if they are ultimately adopted by the Commission.

Q. Which Commission Staff and/or Intervenor Testimony will you be addressing in your Rejoinder Testimony?

A. I will be addressing the Testimony of the following witnesses:

- Ralph C. Smith on behalf of Staff
- David C. Parcell on behalf of Staff
- Marylee Diaz Cortez on behalf of RUCO
- William A. Rigsby on behalf of RUCO

II. <u>RESPONSE TO STAFF WITNESS RALPH SMITH.</u>

Q. What issues raised by Mr. Smith in his Surrebuttal Testimony do you wish to address?

A. There are three issues raised by Mr. Smith that require further discussion. First, I address the standards now articulated by Mr. Smith for the granting of CWIP in rate base, and demonstrate once again why UNS Gas should be permitted to include CWIP in rate base.

Second, I discuss Mr. Smith's characterization of the financial forecasts that were included in my Direct and Rebuttal Testimony. Finally, I address Mr. Smith's concerns regarding the rate treatment of customer advances, and provide an illustrative example of how Staff's position on this issue imposes a financial penalty on UNS Gas.

Q. What standards has Mr. Smith articulated for the purpose of determining whether or not CWIP can be included in rate base?

A. At page 10, lines 16 through 20 of his Surrebuttal Testimony, Mr. Smith states the following:

> "...UNS Gas must show convincingly that it is different in significantly important aspects than the comparable circumstances in the other utility rate cases over the past decades where CWIP was excluded from rate base. In other words, UNS Gas must show how it is different from the normal circumstances of a regulated Arizona public utility where CWIP has been excluded from rate base."

Additionally, at page 11 of his Surrebuttal Testimony, Mr. Smith appears to describe another standard, one based on financial need. At lines 7 through 9 of that page, Mr. Smith makes the following statement:

> "Nor has Mr. Grant demonstrated that UNS Gas is in financial distress, that it cannot continue to attract capital at favorable terms if CWIP continues to be excluded from rate base, or that UNS Gas is different in terms of its customer growth and regulatory lag situation than the other major utilities in Arizona which do not have CWIP included in rate base."

Based on these comments, it appears that Staff is recommending the application of both an "extraordinary circumstances" test and a "financial distress" test in determining whether or not to allow CWIP in rate base.

Q. Do you agree that these standards are appropriate?

A. Yes and no. I do not object to the application of an "extraordinary circumstances" test, since CWIP is not normally included in rate base for regulated utilities. However, I do object to the application of a "financial distress" test.

Q. Please explain.

A. Certainly. By the time a utility can demonstrate that it is in "financial distress," damage to the utility's credit and access to capital has already been done. The whole purpose of including CWIP in rate base is to support the utility's credit and access to capital, and to avoid the increased cost and reduced availability of capital associated with financial distress. If this same standard were applied in a medical setting, only those patients who become critically ill would be eligible for health care. By the time care is finally administered, it may be too late to save the patient.

Q. Has UNS Gas demonstrated that it is facing extraordinary circumstances, and that rate base treatment of CWIP is needed to assure continued access to capital on reasonable terms?

A. Yes. It is readily apparent that UNS Gas is being seriously challenged by the growth in net plant investment required to add new customers and to make necessary system improvements. As documented in Exhibit KCG-15, this rate of growth is substantially higher than the growth experienced by the three largest investor-owned utilities in the State of Arizona, which was recently recognized as being the fastest-growing state in the Union. This situation clearly represents an extraordinary circumstance that warrants special attention by the Commission and by the management of UNS Gas. Additionally, through my Direct and Rebuttal Testimony, I have provided ample evidence of the need for additional capital and the need for timely rate relief as requested by UNS Gas. Without CWIP in rate base, or the inclusion of a substantial post-test year plant

adjustment, it would be difficult for the Company to continue to attract capital on reasonable terms. Under the circumstances, a dose of preventative medicine is clearly preferable to a "wait and see" approach.

Q. At pages 8 and 9 of his Surrebuttal Testimony, Mr. Smith discusses your use of financial projections in support the Company's request for CWIP in rate base. Do you agree with his position on the use of financial forecast information?

A. No, I do not. Mr. Smith does not believe the Commission should place much reliance on financial forecast information, since it is "subject to change and can be inaccurate." However, based on my prior experience in utility rate proceedings, as well as my experience as a utility finance professional, it is essential to consider the financial forecast of a utility seeking rate treatment on the basis of financial integrity. While it is true that financial forecasts change over time, and that they are not perfect predictors of future financial performance, they are nonetheless essential to any discussion of financial integrity. The forecast information provided in my Rebuttal Testimony reflects the best information available to the Company at this time. It is consistent with the forecast information used by management to evaluate short-term borrowing needs, longer-term financing needs, and to prepare estimates of consolidated earnings at UniSource Energy. While it may not be perfect, the financial forecast information contained in Exhibits KCG-13 and KCG-14 (included in my Rebuttal Testimony) represents the best information available concerning the Company's future financial performance under the rate proposals made by UNS Gas and by Staff.

Q. At page 9 of his Surrebuttal Testimony, Mr. Smith criticizes the financial forecast that you prepared in order to reflect Staff's rate proposal. Do you have any reaction to this criticism?

A. Yes. Apparently Mr. Smith believes that this financial forecast should be adjusted to remove costs and expenses that have been disallowed by Staff. Unfortunately, these costs and expenses will not disappear just because Staff recommends disallowance of these costs for rate setting purposes. The financial forecast referenced by Mr. Smith reflects the operating budget and capital budget established for UNS Gas, and this budget was set based on spending levels necessary to maintain high quality service and to expand the Company's facilities to meet customer growth. Unless Mr. Smith is advocating a reduction in service levels or infrastructure investment, there is no reason to adjust the financial forecast as he recommended.

Q. At page 15 of his Surrebuttal Testimony, Mr. Smith states that the Commission's rules require that customer advances be reflected as a deduction from rate base. Do you believe that all customer advances must be deducted from rate base under the Commission's rules?

A. No. I am not aware of any requirement to deduct 100% of customer advances at test year-end from rate base. I believe it is up to the discretion of the Commission to determine how much of the customer advance balance should be used to reduce rate base. For example, in the last Southwest Gas rate case, the company proposed using a thirteen month average of customer advances in lieu of the test year-end balance for purposes of calculating a rate base deduction. This average balance, which was less than the test year-end balance, was incorporated by the Commission in its final rate order.

Q. Mr. Smith also states that the accrual of an allowance for funds used during construction ("AFUDC") also represents a reason to deduct all customer advances from rate base. Do you agree with this position?

A. No. Since most of the projects included in the test year-end CWIP balance were completed fairly quickly, with 94% of the balance closed to plant-in-service by December 31, 2006, the accrual of AFUDC on the test year-end CWIP balance was fairly small, both in absolute terms and relative to the annual revenue requirement on these projects when they were completed. Since UNS Gas did not reduce its accrual of AFUDC to reflect the related balance of customer advances, Mr. Smith is concerned that UNS Gas would earn a "double rate of return" if the entire balance of customer advances is not used to offset rate base. However, as noted above, the amount of any AFUDC associated with customer advances was likely very small, and certainly pales in comparison to the return that UNS Gas will be foregoing on the test year CWIP balance if CWIP is excluded from rate base. By raising this issue, I believe that Mr. Smith is making a mountain out of a mole hill, and is using this issue to unfairly reduce the Company's rate base by the entire balance of customer advances, even those advances that are clearly tied to the test year balance of CWIP.

Q. Can you provide an example of how customer advances are used to fund construction, and how that affects the Company's net investment in a construction project over time?

A. Yes. Exhibit KCG-16 provides an illustrative example using data from a real life project that was included in the test year-end CWIP balance. As may be seen on the left hand side of this exhibit, the process begins with the payment of an advance by the developer, after which the proceeds are used by the Company to construct the gas distribution lines necessary for providing service. As new customers are hooked-up to the completed facilities, repayment of the advanced sum is made to the developer over time according to

the terms of the contract. If a sufficient number of new customers are not added by the end of the five-year contract term, then all or a portion of the advance would be converted to a contribution in aid of construction ("CIAC") and used to reduce the Company's net plant investment.

As may be seen on the right hand side of this exhibit, a total of $167,327 was advanced in June 2005 for the construction of this particular project. Since customer advances are treated as taxable income by the Internal Revenue Service, the Company recorded a tax liability equal to approximately 40% of the amount advanced. By the end of 2005, a total of $102,797 had been expended on construction of the project, with this amount being recorded as CWIP on the Company's books. As may be seen, the Company's investment in the project, net of the customer advance and related tax liability, was $2,401 as of the end of the test year. The project was then completed and transferred to plant-in-service in the first quarter of 2006 at a total cost of $207,680. The Company's net investment at that time, only 90 days after the end of the test year, was $107,284. Assuming that new customers are added in sufficient numbers to allow for a partial repayment of the advance in 2007 and full repayment in 2008, the Company's net investment in the project will increase to $207,680 by the end of 2008. For the sake of simplicity, accruals of depreciation expense and deferred income tax expense were not included in this schedule.

Q. If CWIP is excluded from rate base, and Mr. Smith's recommendation on customer advances is adopted, how would this project be reflected in rate base?

A. The Company's test year rate base would be reduced by $167,327, despite having a net positive investment of $2,401 in the project.

Q. Did the Company continue to accrue AFUDC on the project after the end of the test year, thereby offsetting the impact of not having CWIP in rate base?

A. The Company did continue to accrue AFUDC on the project until it was completed in the first quarter of 2006. However, the amount of AFUDC recorded was quite small and ceased in its entirety by March 31, 2006.

Q. If CWIP is included in rate base as proposed by the Company, how would this project be reflected in rate base?

A. The CWIP balance of $102,797 would be included in rate base, offset by the $167,327 in customer advances. Although the Company would experience a net reduction to rate base of $64,530, this amount is considerably less than the rate base deduction that would result from Staff's recommended approach. Additionally, since the aggregate balance of test year CWIP exceeds the aggregate balance of test year advances by approximately $3 million, the Company's approach would result in a net increase to rate base with related benefits to both earnings and cash flow.

Q. Please summarize the aggregate impact on rate base associated with the Company's position and Staff's position on the issue of CWIP and customer advances.

A. Certainly. Exhibit KCG-17 provides a summary of the rate base impact under each proposal. As may be seen, the Company's proposal would increase rate base by approximately $3 million, reflecting the Company's $7 million investment in CWIP net of $4 million in related customer advances. In contrast, Staff's proposal would serve to reduce rate base by the $4 million balance of customer advances, a position that clearly penalizes the Company. At a minimum, if Staff still believes that CWIP should be excluded from rate base, the related $4 million balance of customer advances should not be used to reduce rate base. The last row of Exhibit KCG-17 reflects this adjustment to Staff's position.

Q. Does that conclude your response to the Surrebuttal Testimony of Mr. Smith?

A. Yes, it does.

III. RESPONSE TO STAFF WITNESS DAVID PARCELL.

Q. What aspects of Mr. Parcell's Surrebuttal Testimony are you addressing in your rejoinder Testimony?

A. I address several issues raised in Mr. Parcell's Surrebuttal Testimony. These issues include the proper use of and reliance on the CAPM, the risk of investing in UNS Gas relative to other gas distribution utilities, the appropriate capital structure for UNS Gas, and Mr. Parcell's recommendation concerning the appropriate ROR to be applied to FVRB.

Q. At page 2 of his Surrebuttal Testimony, Mr. Parcell refers to your "exclusive reliance" on the CAPM in formulating a cost of equity recommendation. Did you rely exclusively on your CAPM analysis and ignore the results of your DCF analysis?

A. No. As described in my Direct Testimony, I used both the CAPM and the DCF model to estimate the cost of equity for a comparable group of gas distribution utilities. I then compared the risk of UNS Gas relative to the comparable company group, and determined that the cost of equity for UNS Gas lies at the high end of the range for that group (9.5% to 11.0%). Although the results of the CAPM were used to establish the high end of this range, that does not mean I relied exclusively on the CAPM for purposes of recommending an appropriate ROE for UNS Gas.

Q. At pages 3 and 4 of his Surrebuttal Testimony, Mr. Parcell makes a case for using geometric mean returns to derive the market risk premium in the CAPM. Do you concur with Mr. Parcell's conclusion that both geometric mean returns and arithmetic mean returns should be considered?

A. No, I do not. As stated below in my response to RUCO witness William Rigsby, arithmetic mean returns are more relevant to investors when forming expectations of future investment returns. Mr. Parcell's references to the geometric returns published by mutual fund companies and Value Line are not particularly relevant, since they refer to past historical performance as opposed to future expected performance. As I have stated previously, it is common to use the compound or geometric average of investment returns when comparing the performance of different investments over historical time periods.

Q. At page 5 of his Surrebuttal Testimony, Mr. Parcell states that I refer to "size" as the "primary Company-specific risk factor" facing UNS Gas. Is that characterization accurate?

A. No, it is not. The small size of UNS Gas relative to other gas distribution utilities is only one of the factors I cited. In fact, I devoted significantly more discussion to the risks associated with high customer growth and regulatory lag.

Q. Should the allowed ROE for UNS Gas depend on who owns the Company's stock as Mr. Parcell advocates, or should it instead be based on the risks to which the capital is exposed?

A. The allowed return should be based on the risk to which the capital is exposed, and not on the identity of the shareholder making such an investment. Although UNS Gas is clearly part of a larger corporate family, the fact that UNS Gas is relatively small and faces other company-specific risks is just as relevant to UniSource Energy Corporation as it would be to any other potential shareholder of UNS Gas.

Q. At page 6 of his Surrebuttal Testimony, Mr. Parcell states that you offered "no reasons at all" why the Commission should adopt a hypothetical capital structure for UNS Gas. Is that statement accurate?

A. No, it is not. The reasons I offered for using a hypothetical capital structure may be found at pages 8 through 10 of my Direct Testimony. I found it encouraging that at least one party to this case, RUCO, was willing to consider my recommendation and adopt it as part of their filing.

Q. With regard to establishing a ROR on FVRB, Staff witnesses David Parcell and Ralph Smith repeatedly state that the Commission is not required to use the weighted average cost of capital applied to original cost rate base ("OCRB"). Is that your opinion as well?

A. Yes. My non-legal opinion is that the Commission has wide latitude in setting a reasonable ROR on fair value rate base. However, the ROR must still be adequate to support the credit of the Company and to allow it to access capital on reasonable terms.

Q. Why do you recommend using the weighted average cost of capital as the ROR on fair value rate base?

A. For two reasons. First, it seems to be the most straightforward solution to the issue raised by the Court of Appeals in the recent Chaparral case. Second, it will not result in a larger rate increase than originally requested by UNS Gas. That is because the Company is willing limit the rate increase to the amount it applied for last July.

Q. Mr. Parcell has recommending applying a zero percent cost of capital to the difference between FVRB and OCRB. Do you view his recommendation as being responsive to the recent Court of Appeals ruling?

A. No, I do not. Although I am not a lawyer, and am not offering a legal opinion, it apparent that this approach is mathematically equivalent to the approach previously used by Staff and expressly rejected by the Court of Appeals in the Chaparral case.

Q. At page 9 of his Surrebuttal Testimony, Mr. Parcell states that "...the cost of capital cannot be applied to the fair value rate base since there is no financial link between the two concepts." Do you agree with this statement?

A. No, I do not. The fair value of a utility's assets has a subtle, yet very real, impact on a utility's cost of capital. To the extent that fair value exceeds original cost, lenders will be more comfortable with the collateral securing their loans and will tend to extend more credit to the utility on better terms. Likewise, shareholders may be more willing to commit capital if they believe that fair value exceeds original cost by a substantial margin. That is because such value could potentially be unlocked through a sale of the Company, a sale of assets, or a spin-off of assets to shareholders. As a result, the cost of capital is likely lower for a utility having a fair value that is substantially higher than original cost. Since customers benefit from this lower cost of capital, it would not be unreasonable to allow shareholders to share a portion of this benefit as well.

Q. Does that conclude your response to the Surrebuttal Testimony of Mr. Parcell?

A. Yes, it does.

IV. RESPONSE TO RUCO WITNESS MARYLEE DIAZ CORTEZ.

Q. What issues raised by Ms. Diaz Cortez in her Surrebuttal Testimony do you care to address in this rejoinder Testimony?

A. My comments address that portion of her Surrebuttal Testimony pertaining to the rate base treatment of contributions in aid of construction ("CIAC"). Although UNS Gas did not raise the issue of CIAC in its Rebuttal Testimony, it appears that she views CIAC as being equivalent to customer advances, a topic the Company did raise in its Rebuttal Testimony. Additionally, I provide a brief response to the comments made by Ms. Diaz Cortez on the appropriate ROR to be applied to FVRB.

Q. Is CIAC the same as a customer advance?

A. No, it is not. A contribution in aid of construction is permanent and is recorded as a reduction to net plant at the time of the contribution. In contrast, a customer advance represents a form of financing, an amount that must be repaid to the developer if new customers are added over the timeframe specified by contract. If a sufficient number of new customers are not added by the time specified in the contract, then all or a portion of the advance will be retained by the utility and treated as a CIAC for accounting purposes.

Q. In what context did Ms. Diaz Cortez raise the issue of CIAC?

A. On page 8 of her Surrebuttal Testimony she discusses the treatment of CIAC as part of her discussion on CWIP in rate base. Based on her references to the Company's position on CWIP in rate base, I believe she is using the term CIAC interchangeably with customer advances.

Q. Assuming she is referring to the rate treatment of customer advances, do you agree with her position that all customer advances should serve to reduce rate base even if CWIP is excluded from rate base?

A. No, I do not. This issue was addressed previously in my Rebuttal Testimony, and was discussed above in response to the Surrebuttal Testimony filed by Staff witness Ralph Smith.

Q. At page 3 of her Surrebuttal Testimony, Ms. Diaz Cortez claims that the Company revised its original rate application to reflect the recent Court of Appeals ruling involving Chaparral City Water Company. Did the Company revise its original application as claimed by Ms. Diaz Cortez?

A. No. The Company is still seeking the rate relief it sought when the case was originally filed in July 2006. The only exception to this pertains to some minor downward adjustments that were explained by Mr. Dukes in his Rebuttal Testimony which caused our requested rate increase to fall from $9.647 million to $9.487 million. The discussion of the Chaparral case provided in my Rebuttal Testimony was not intended to generate additional rate relief above and beyond that originally requested by UNS Gas. Instead, my comments were offered under the belief that this recent court ruling will be at least relevant to the setting of a fair ROR for utilities operating under the Commission's rate authority.

Q. Does that conclude your response to the Surrebuttal Testimony of Ms. Diaz Cortez?

A. Yes, it does.

V. RESPONSE TO RUCO WITNESS WILLIAM A. RIGSBY.

Q. What aspects of Mr. Rigsby's Surrebuttal Testimony are you addressing in this Rejoinder Testimony?

A. There are four issues I wish to address. Specifically, I would like to address Mr. Rigsby's views on the appropriate long-term growth rates to be used in a discounted cash flow ("DCF") analysis, his views on the use of geometric versus arithmetic mean returns in calculating an appropriate risk premium to be used in the capital asset pricing model ("CAPM"), his position on the risk of investing in UNS Gas relative to other gas distribution utilities, and his characterization of the Company's proposal for a rate decoupling mechanism.

Q. At pages 6 through 9 of his Surrebuttal Testimony, Mr. Rigsby offers additional support for the widely divergent growth rates used in his constant growth DCF analysis. Do you concur with the views expressed in that section of his Testimony?

A. No, I do not. Instead of focusing on the issue of estimating dividend growth rates over the *long-run*, which I raised in my Rebuttal Testimony, Mr. Rigsby focuses his discussion on the divergence of utility growth rates over the *short-run*, and makes several comments that mischaracterize statements made in my Rebuttal Testimony. Contrary to Mr. Rigsby's assertions, nowhere in my testimony have I suggested that investors look at all gas utility stocks as being equivalent to one another. Just like Mr. Rigsby, I devoted a significant amount of time evaluating the risk profile and near-term growth estimates for each company included in my DCF analysis, and in fact used a very wide range of growth rates over the first five years of that analysis. However, where I differ with Mr. Rigsby is in the selection of sustainable *long-term* growth rates. Mr. Rigsby blindly assumes that a three to five-year growth rate will continue into perpetuity for each of the companies in his DCF analysis, irrespective of the fact that all of these companies are

members of same regulated industry and are impacted by same macroeconomic factors affecting the United States economy as a whole.

Q. At pages 12 through 16 of his Surrebuttal Testimony, Mr. Rigsby provides a lengthy discourse on the merits of using geometric mean returns to quantify the expected market risk premium in the CAPM. Do you agree with his conclusion that geometric mean return data should be used when applying the CAPM?

A. No, I do not. And given that Mr. Rigsby has offered a numerical example to support his position, I feel compelled to offer an example of my own.

Q. What issues do you have with the numerical example provided at pages 13 and 14 of Mr. Rigsby's Surrebuttal Testimony?

A. First, the example used by Mr. Rigsby involves the loss of capital on an investment. Since rational investors do not *expect* to lose money on their investments, this example is of limited value in assessing future return expectations. Second, the example is self-fulfilling, since the investment returns (or losses) are presented on an ex post basis. As was previously discussed in my Rebuttal Testimony, the geometric average is commonly used to report historical return performance. However, that does not make it suitable for the calculation of a forward-looking risk premium in the CAPM.

Q. How would you adjust Mr. Rigsby's example to make it relevant to a discussion of expected future returns?

A. First, I would state the investor expectations on an ex ante basis. Second, I would describe the expected returns as a range of potential outcomes having an expected value that is positive. Third, in order to simplify the example as Mr. Rigsby did, I would express the range of expected annual returns as either a positive return or negative return, with a 50% probability of realizing either return in a given year. If these returns are

expressed as either a 30% positive return or a 10% negative return, the expected return in any given year would be 10% positive, calculated as follows:

$$\begin{aligned}\text{Expected annual return} &= (30\% \times 0.5) + (-10\% \times 0.5)\\ &= 15\% - 5\%\\ &= 10\%\end{aligned}$$

Over a two year period, if $100 is invested at the outset, the range of expected outcomes would be as follows, listed from best to worst:

Outcome 1 = $100 x (1.30) x (1.30) = $169

Outcome 2 = $100 x (1.30) x (0.90) = $117

Outcome 3 = $100 x (0.90) x (1.30) = $117

Outcome 4 = $100 x (0.90) x (0.90) = $81

Since each outcome has a 25% chance of occurring, the expected outcome on a probabilistic basis is $121, calculated as follows:

$$\begin{aligned}\text{Expected Outcome} &= (\$169 \times 0.25) + (\$117 \times 0.25) + (\$117 \times 0.25) + (\$81 \times 0.25)\\ &= \$121\end{aligned}$$

The annual rate of return corresponding to this expected outcome is 10%, which represents the arithmetic average of the expected annual returns of 30% and minus 10%. This is demonstrated as follows:

Expected Outcome = $100 x 1.10 x 1.10 = $121

By contrast, if the geometric average of expected annual returns is used to forecast expected outcomes, the expected ending value will be understated on a probability-weighted basis. That is because the geometric average of 8.2% (calculated below) produces an expected ending value of only $117:

$$\text{Geometric Average Return} = (1.30 \times 0.90)^{1/2} - 1.0$$
$$= (1.17)^{1/2} - 1.0$$
$$= .082$$
$$\text{Expected Outcome} = \$100 \times 1.082 \times 1.082$$
$$= \$117$$

As demonstrated by this simple example, use of the arithmetic mean return is more relevant to an investor when forming expectations of future potential returns. Use of the geometric mean return, on the other hand, serves to understate the future expected returns on a probability-weighted basis, and is more relevant to a calculation of historical investment returns.

Q. At pages 10 through 12 of his Testimony, Mr. Rigsby dismisses the additional risks faced by UNS Gas relative to other gas distribution utilities. Are these risks real and relevant to the setting of an allowed ROR for UNS Gas?

A. Yes, these additional risks are both real and relevant to the setting of a reasonable ROR for UNS Gas. Unfortunately, Mr. Rigsby would prefer to ignore these risks and avoid any discussion of how to quantify the cost of this risk. For example, at page 10 of his Surrebuttal Testimony (lines 19 through 23), Mr. Rigsby states that "...high customer growth has been business as usual and a fact of life for utilities operating in the Arizona jurisdiction for the last fifty years." He goes on to state that "If a utility's management can't deal with that fact of life then they should consider getting into another business."

Q. Has UNS Gas attempted to quantify the financial burden associated with high customer growth and regulatory lag?

A. Yes. Included in both my Direct and Rebuttal Testimony are tables demonstrating the extraordinary amount of growth in net plant investment that has occurred in order to meet customer growth and to maintain a highly reliable gas distribution system. Additionally, I have provided financial forecasts demonstrating that it is highly unlikely that UNS Gas will actually be able to earn its requested ROE, even if the Company's rate request is granted in its entirety. I have also provided an analysis, contained in Exhibit KCG-10 attached to my Rebuttal Testimony, that demonstrates the short-term financial impact of high plant growth and regulatory lag on UNS Gas. Although this growth can be beneficial over the long-term, as described in my Rebuttal Testimony, it is clearly detrimental to UNS Gas over the short-run due to the use of an historical test year to set rates. As a consequence, I do not find Mr. Rigsby's comments on the subject of growth to be particularly helpful.

Q. What are the consequences of earning a below-market ROE?

A. If a firm cannot earn its cost of capital on new capital investments, investors will pull out of the firm and deploy their capital elsewhere. If a firm continues to under-earn on its capital investments, the market value of the firm will shrink and the cost of capital will eventually rise in response to a weakened financial profile. From the standpoint of a regulated utility, an increasing cost of capital and a weakened financial profile are not in the best interest of consumers. As a consequence, even if Mr. Rigsby is not concerned about making "tough luck" comments aimed at management, he should be concerned about how such comments are perceived by investors.

Q. Do you have any other observations regarding the impact of growth and regulatory lag on UNS Gas?

A. Yes. Prompted in part by the comments of Mr. Rigsby, as well as the Surrebuttal Testimony of Staff witness Ralph Smith, the Company examined growth rate data for the three largest investor-owned utilities in Arizona. The results of that examination are contained in Exhibit KCG-15. The source data for this exhibit was taken from Securities and Exchange Commission filings and from SNL DataSource, a financial database containing publicly available information on investor-owned utilities.

As may be seen in Exhibit KCG-15, since 1995 the compound annual growth rate in net plant investment has ranged from a low of 3.7% for Tucson Electric Power Company ("TEP") to a high of 8.1% for Southwest Gas Corporation ("SWG"). By contrast, the compound annual growth rate for UNS Gas was 10.6% over the past three years and is forecasted to be 11.0% over the next three years. In terms of absolute growth over the past three years, the growth in net plant investment has ranged from a low of 11.6% for TEP to a high of 28.9% for Arizona Public Service Company ("APS"), a value inflated by the recent transfer of the Redhawk and West Phoenix generating facilities to APS. By contrast, UNS Gas has experienced a 35.4% increase in net plant investment since December 2003.

On a per-customer basis, the growth in net plant investment experienced by UNS Gas is even more pronounced. Since 1995 the compound annual growth in net plant investment per customer has ranged from a low of 0.9% for APS to a high of 2.6% for SWG. By contrast, UNS Gas has experienced a compound growth rate of 6.0% over the past three years and is forecasted to be 6.1% over the next three years. In terms of absolute growth over the past three years, the growth in net plant investment per customer has ranged

from a low of 3.1% for SWG to a high of 14.3% for APS. By contrast, UNS Gas experienced a 19.1% increase in net plant investment per customer since December 2003.

The key point to be made here is that UNS Gas is growing substantially faster than any of the major investor-owned utilities in Arizona when measured in terms of net plant investment. On an absolute basis, this growth rate indicates a substantial need for new debt and equity capital. On a per-customer basis, this growth rate indicates the severity of the financial challenge faced by UNS Gas in a regulatory jurisdiction that requires the use of an historical test year and embedded cost pricing principles.

Q. On page 10 of his Surrebuttal Testimony, Mr. Rigsby states that the implementation of a rate decoupling mechanism would "...remove all of the risk associated with operating income volatility," and implies that UNS Gas is seeking a "guaranteed return on investment." Are those statements accurate?

A. No, they are not. While the proposed rate decoupling mechanism is designed to *reduce* the volatility of operating income, it cannot *eliminate* operating income volatility nor provide UNS Gas with a "guaranteed" return on investment. The Company would still be at risk for its recovery of operation and maintenance expenses, property taxes and depreciation expense. Additionally, UNS Gas would also be at risk for the return requirements on new capital investment. The proposed decoupling mechanism only serves to provide additional assurance that the Company will actually be able to collect the delivery revenues determined to be appropriate in this proceeding, based on costs and usage levels for the test year ending December 31, 2005.

Q. Have the rating agencies commented on the credit implications of rate decoupling mechanisms?

A. Yes, they have. In June 2006 Moody's Investors Service provided substantial commentary on the credit rating implications of rate decoupling mechanisms. A copy of that report is attached as Exhibit KCG-18 to this Rejoinder Testimony. On the first page of that report, Moody's offers the following observation:

> "LDCs (local distribution companies) that have, or soon expect to have, RD (revenue decoupling) stand a better chance than others in being able to maintain their credit ratings or stabilize their credit outlook in face of adversity. This difference between those companies that have RD and those that do not will tend to be further accentuated as the credit demarcation reflected through rating actions becomes more evident."

On page 4 of that same report, Moody's goes on to describe the problems associated with traditional gas utility rate design:

> "In attempting to grapple with the conservation issue, LDCs are in fact, having to dispel the notion that their fixed charges should be recovered from volumetric sales of gas. As the fixed charges appear year in and year out regardless of gas usage, the volumetric approach to cost recovery for operating a gas distribution system is a faulty equation which needs to be rectified in ratemaking. It would appear, therefore, that unless and until this anomaly is corrected, the LDC would lack the necessary tools with which to earn its allowed rate of return."

Later in that same report, Moody's makes reference to several utilities that have already received regulatory approval for rate decoupling mechanisms, and to others who are in the process of applying for this rate treatment.

Q. If the Company's rate decoupling mechanism is approved by the Commission, would a reduction to the Company's allowed ROE be warranted as suggested by Mr. Rigsby?

A. No. At least four of the companies in my comparable company group already have rate decoupling mechanisms, and at least three others have weather normalization clauses that adjust revenues to compensate for abnormal sales levels due to weather conditions. Even if a rate decoupling mechanism is approved, an equity investment in UNS Gas would still be much riskier than most gas utilities due to the Company's small size, the combined effects of high customer growth and regulatory lag, and the lack of any common dividend payment. On the contrary, if the Commission were to leave the Company's volumetric rate design largely intact, I would recommend an even higher ROE for use in this proceeding.

Q. Does that conclude your response to the Surrebuttal Testimony of Mr. Rigsby?

A. Yes, it does.

VI. CONCLUSION.

Q. Mr. Grant, do you have any concluding remarks?

A. Yes, I do. It should be abundantly clear by this point that UNS Gas is facing an extraordinary challenge in meeting the growth occurring on its system. It is because of this growth, as well as increases in both operating and capital costs, that the Company is seeking a rate increase at this time. As discussed, a critical component of the Company's rate request is the proposal to include the test year balance of CWIP in rate base. This request should be granted based on the need to maintain continued access to capital on reasonable terms. Additionally, in light of the company-specific risks faced by UNS Gas, it would be reasonable to grant the Company an allowed ROE that is higher than the

returns awarded to larger and more established publicly traded utilities. Finally, substantial changes to the Company's rate design are also warranted. Due to high natural gas prices, customer conservation and highly variable weather conditions, it is becoming increasingly difficult for UNS Gas to maintain an adequate and consistent level of earnings and cash flow under a volumetric rate design.

Q. Does this conclude your Rejoinder Testimony?

A. Yes, it does.

EXHIBIT

KCG-15

Growth Rates Experienced by Arizona Utilities

Southwest Gas Corporation

	Net Plant ($ Millions)	Customers	Investment per Customer
1995	$1,138	985,043	$1,155
1996	$1,278	1,044,506	$1,224
1997	$1,360	1,104,060	$1,232
1998	$1,459	1,162,831	$1,255
1999	$1,581	1,224,770	$1,291
2000	$1,686	1,289,104	$1,308
2001	$1,826	1,348,970	$1,354
2002	$2,034	1,407,286	$1,445
2003	$2,176	1,467,752	$1,483
2004	$2,336	1,550,509	$1,507
2005	$2,489	1,645,004	$1,513
2006	$2,668	1,745,125	$1,529
Compound Annual Growth Rate (1995 - 2006)	8.1%	5.3%	2.6%
Absolute Growth Over Last 3 Years (2003 - 2006)	22.6%	18.9%	3.1%

Arizona Public Service Company

	Net Plant ($ Millions)	Customers	Investment per Customer
1995	$4,647	704,993	$6,592
1996	$4,655	737,504	$6,312
1997	$4,678	766,531	$6,103
1998	$4,731	796,410	$5,940
1999	$4,753	826,935	$5,748
2000	$4,910	864,990	$5,676
2001	$5,059	892,805	$5,666
2002	$5,886	921,251	$6,389
2003	$6,070	953,251	$6,368
2004	$6,258	989,502	$6,324
2005	$7,525	1,033,423	$7,282
2006	$7,827	1,075,191	$7,280
Compound Annual Growth Rate (1995 - 2006)	4.9%	3.9%	0.9%
Absolute Growth Over Last 3 Years (2003 - 2006)	28.9%	12.8%	14.3%

Growth Rates Experienced by Arizona Utilities

Tucson Electric Power Company

	Net Plant ($ Millions)	Customers	Investment per Customer
1995	$1,125	302,517	$3,719
1996	$1,117	310,950	$3,592
1997	$1,116	316,895	$3,522
1998	$1,114	324,866	$3,429
1999	$1,293	334,137	$3,869
2000	$1,298	342,914	$3,786
2001	$1,299	350,938	$3,701
2002	$1,480	359,372	$4,118
2003	$1,506	367,239	$4,101
2004	$1,538	375,532	$4,096
2005	$1,616	384,898	$4,199
2006	$1,681	392,477	$4,283
Compound Annual Growth Rate (1995 - 2006)	3.7%	2.4%	1.3%
Absolute Growth Over Last 3 Years (2003 - 2006)	11.6%	6.9%	4.4%

UNS Gas, Inc.

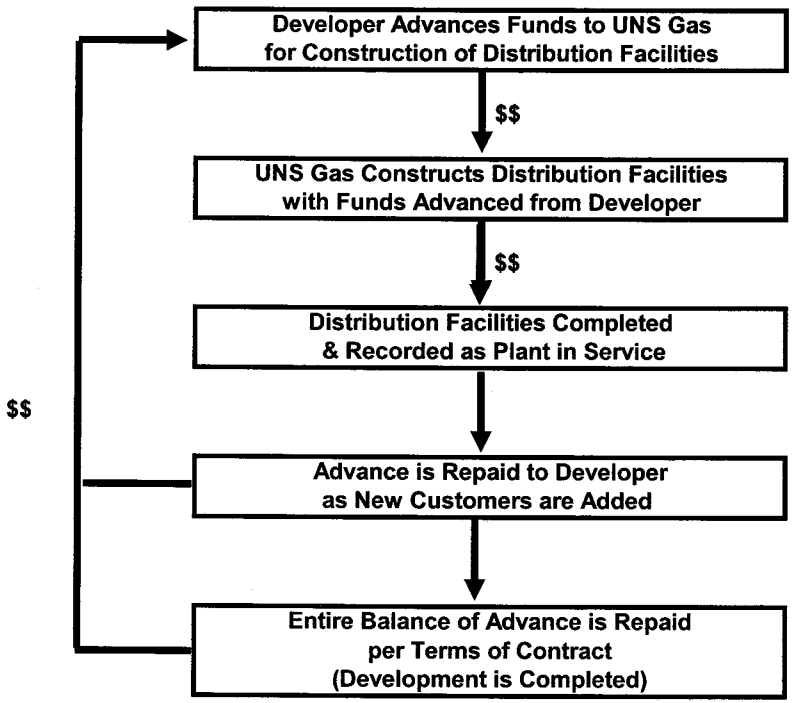
	Net Plant ($ Millions)	Customers	Investment per Customer
2003	$144	127,577	$1,129
2004	$161	133,403	$1,207
2005	$177	138,797	$1,275
2006	$195	145,052	$1,344
2007 Fcst.	$225	150,962	$1,490
2008 Fcst.	$249	158,439	$1,572
2009 Fcst.	$267	166,453	$1,604
Compund Annual Growth Rates			
2003-2006	10.6%	4.4%	6.0%
2006-2009 Fcst.	11.0%	4.7%	6.1%
Absolute Growth			
2003-2006	35.4%	13.7%	19.1%
2006-2009 Fcst.	36.9%	14.8%	19.3%

EXHIBIT

KCG-16

Exhibit KCG-16

UNS Gas, Inc.
Example of Construction Project Funding with Customer Advances



Event	Event Timeline	Net Investment in Project by UNS Gas, Inc.					
		Date	CWIP	Plant in Service	Advance	Tax Liab. on Advance	Net Investment
Developer Advances Funds to UNS Gas for Construction of Distribution Facilities	2Q 2005	6/30/2005	$ -	$ -	$ (167,327)	$ 66,931	**$ (100,396)**
UNS Gas Constructs Distribution Facilities with Funds Advanced from Developer	3Q 2005 Through 1Q 2006	12/31/2005	$ 102,797	$ -	$ (167,327)	$ 66,931	**$ 2,401**
Distribution Facilities Completed & Recorded as Plant in Service	1Q 2006	3/31/2006	$ -	$ 207,680	$ (167,327)	$ 66,931	**$ 107,284**
Advance is Repaid to Developer as New Customers are Added	2006 Through 2008	12/31/2007	$ -	$ 207,680	$ (83,664)	$ 33,465	**$ 157,482**
Entire Balance of Advance is Repaid per Terms of Contract (Development is Completed)	2008	12/31/2008	$ -	$ 207,680	$ -	$ -	**$ 207,680**

EXHIBIT

KCG-17

Exhibit KCG-17

UNS Gas, Inc.
Impact of CWIP and Customer Advances on Test Year Rate Base

	Balance of CWIP	Balance of Advances Related to CWIP	Net Impact on Rate Base
Company Proposal	$ 7,189,231	$ (4,158,264)	$ 3,030,967
Staff Proposal	$ -	$ (4,158,264)	$ (4,158,264)
Staff Proposal Adjusted for Customer Advances	$ -	$ -	$ -

EXHIBIT

KCG-18

Special Comment

June 2006

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Local Gas Distribution Companies: Update on Revenue Decoupling And Implications for Credit Ratings

Summary Opinion

- With natural gas prices expected to remain at high levels, local gas distribution companies (LDCs) face earnings and cash flow pressures as their customers increase conservation efforts. In addition, bad debt expense has increased as more customers face increasing difficulties in paying their bills. Furthermore, LDC volumes remain subject to weather conditions.
- Moody's analyzed its gas LDCs (local distribution companies) and notes that weather normalized winter gas consumption in per customer usage has declined at an increased pace since 2003. This decline coincides with a period of steadily rising natural gas prices for the LDCs and steadily falling heating degree days.
- Had gross margins (gas revenues less cost of gas and associated gas taxes) been fully protected against gas consumption declines on account of customer conservation during the past five winters, they would have been higher by an average of $5.2 million in 2004 and $4.6 million in 2005. One company would have increased its profits by $18.3 and $11.6 million in those two years (3% and 2% of gas margins, respectively).
- Bad debt expense has shown a steady average increase in each of the past four winters, tracking the increase in natural gas prices during the same period.
- Despite the general increase in working capital and natural gas prices, LDC short-term debt has remained relatively flat from 2003-2005.
- Except for a handful of jurisdictions that employ full revenue decoupling (RD) through a mechanism akin to "balancing accounts" (California, Maryland and North Carolina), most companies prefer to keep the weather normalization clause (WNC) rate design separate from the conservation margin tracker.
- While some jurisdictions permit the application for RD to be requested outside the procedural norms of a full rate case, most would prefer a full rate case or rate review.
- LDCs pursuing a full or partial RD feel that it is an important aspect of their rate design requirements and most companies indicated that they would continue filing for it until their regulators gave final approval.
- Moody's observes that in the face of volatile natural gas prices, volatile weather patterns and other exogenous forces that would prompt gas customers to curtail gas consumption volumes from their utilities, LDC earnings and credit metrics will come under pressure.
- LDCs that have, or soon expect to have, RD stand a better chance than others in being able to maintain their credit ratings or stabilize their credit outlook in face of adversity. This difference between those companies that have RD and those that do not will tend to be further accentuated as the credit demarcation reflected through rating actions becomes more evident.

Moody's Investors Service
Global Credit Research

Introduction

At this time last year, Moody's published its first study dedicated to the question of gas conservation and its impact on gas LDC earnings and credit ratings (see Moody's June 2005 Special Comment titled *Impact of Conservation on Gas Margins and Financial Stability in The Gas LDC Sector)*. We found that while many companies were aware of the conservation factor and 18 of the 34 gas LDCs followed by Moody's could quantify the loss in their per customer volume consumption, only a handful of companies had taken the step to incorporate it into their rate design so that their gross margins would be unaffected. Last year we also discussed how three companies were approaching this rate design feature through slightly different decoupling mechanisms. While the approach may be different, the concept and end result are not. Companies in the gas utility business are increasingly interested in not only protecting themselves against gross margin variations caused by customer conservation (partial decoupling), but also by weather variations (full decoupling).

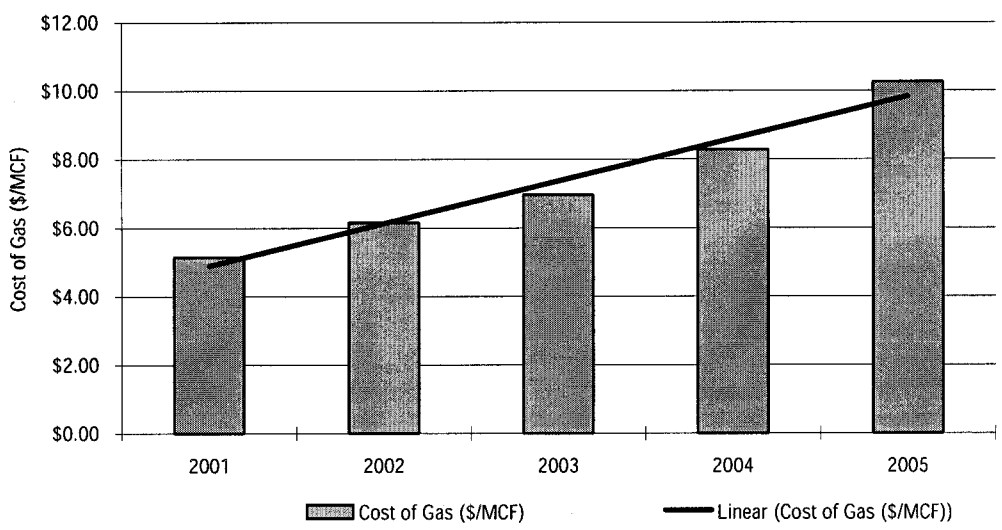
In keeping with the evolving convention, we will refer to these mechanisms as revenue decoupling (RD) in general terms and to "partial decoupling" to mean rate design protection for conservation or "full decoupling" to mean rate design protection for both conservation and weather variations. When a company only has weather normalization clause protection, we refer to the rate design as WNC. Fewer companies have conservation rate design protection without also having WNC as permanent features of their ratemaking.

As with our previous study, we define "conservation" as any technical advancement that improves home heating or gas appliance efficiencies as well as the curtailment of consumption on account of high gas commodity prices. Twenty three of the 34 gas LDCs followed by Moody's responded to various questions posed by Moody's and their results have been tabulated and presented in this paper in aggregate form in order to protect the confidentiality of information submitted.

Nationwide Trend of Rising Gas Prices and Falling Heating Degree Days

Companies overall responded that they were experiencing rising natural gas prices during the past five winter heating seasons, with their average gas purchase prices depicted in the graph below and labeled Increase in Cost of Gas (Fig.1). Natural gas prices rose by a compounded average growth rate of 17% during this period, with the sharpest rise occurring in the winter of 2005 (most recent winter heating season) where it registered an average price increase of 24% over 2004. The highest price recorded by an LDC during this past winter was $13.31/mcf and lowest $6.73/mcf with $10.70 being the median. While only half the respondents provided natural gas price estimates for 2006, those that did resulted in an average price of $10.71/mcf with $13.87/mcf being the highest, $8.61/mcf being the lowest and $10.59/mcf being the median. Most LDCs expect future natural gas prices to moderate, but the trend is still in an upwards direction and this has been found to be the prime driver for the conservation factor on the part of customers.

Figure 1
Increase in Cost of Gas to LDCs

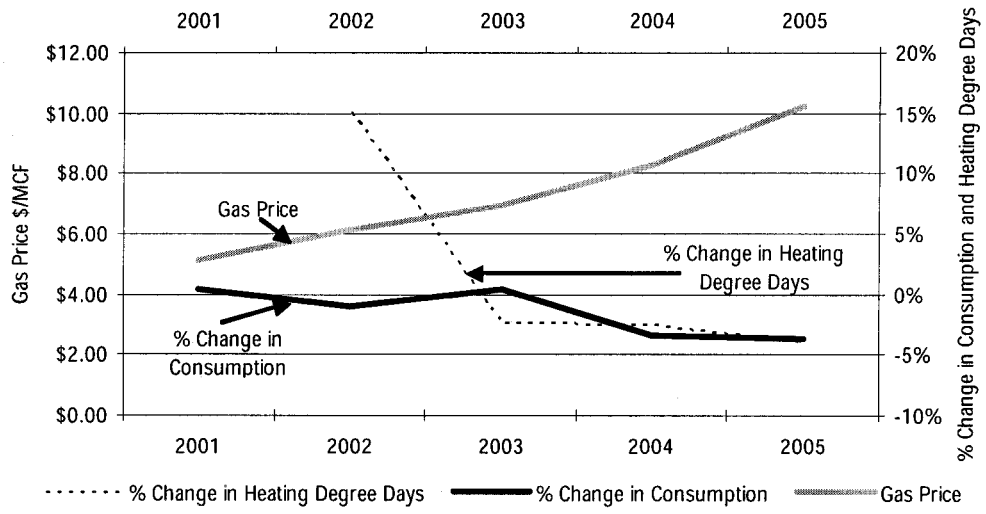


The other noticeable trend is that of falling heating degree days since the winter of 2002 among the responding LDCs. On average, the winter of 2002 appears to have been a fairly cold winter, but the number of heating degree days has since fallen by an average of 3-5% in each of the winter heating seasons since that year. LDCs lacking a WNC or full decoupling mechanism would have suffered in their gas consumption and gross margins when faced with the strong combination of warmer than normal winters and declining gas consumption on account of customer conservation.

Finally, except for a period in 2003 when the average customer consumption increased by .5%, the per customer consumption for residential and commercial users has fallen by 3-4% in each of the last two winter heating seasons on a weather normalized basis, representing that portion of loss in gas consumption resulting from conservation. Changes in gas prices are plotted against percentage changes in per customer consumption and heating degree days in Fig. 2. We note that while the change in per customer consumption on account of conservation has been declining since the 2003 winter heating season at a rate of 3-4% p.a., gas prices have continued to rise much more rapidly.

Figure 2

Gas Price vs. % Change in Consumption and Heating Degree Days



The winter of 2005 saw the most dramatic rise in both natural gas prices and also per customer gas consumption decline on account of conservation (4% average decline). The weather normalized consumption decline for the last winter ranges from 9.1% in the case of one LDC to a gain of 3.1% in another, as it had colder winter weather in 2005 compared with 2004. With the exception of another LDC that had no loss in consumption, all the other respondents had declines in gas consumption. Similarly, except for one LDC which experienced an increase in per customer consumption in 2004 of 1.2%, all others saw declines in per customer consumption from 2003 which ranged from -0.2% to -9.6%.

Impact of Conservation on Losses in Gross Margin

When LDCs were asked how much higher would their gross margins (gas revenues less cost of gas purchased and associated gas taxes) have been had they been fully protected against declines in gas consumption resulting from conservation, all indicated higher gross margins for the last two winter heating seasons. The average gross margins would have increased from a low of $2.4 million in 2003 to a high of $5.2 million in 2004, with one company indicating that they would have gained $18.3 million in 2004 alone and $11.6 million in 2005, where the average company stood to gain an additional $4.6 million in gross margin.

The problem of declining gross margins on account of per customer conservation is explained by the various rate filings and testimonies being offered by consultants on the subject. Symptomatic of the LDC conservation problem is

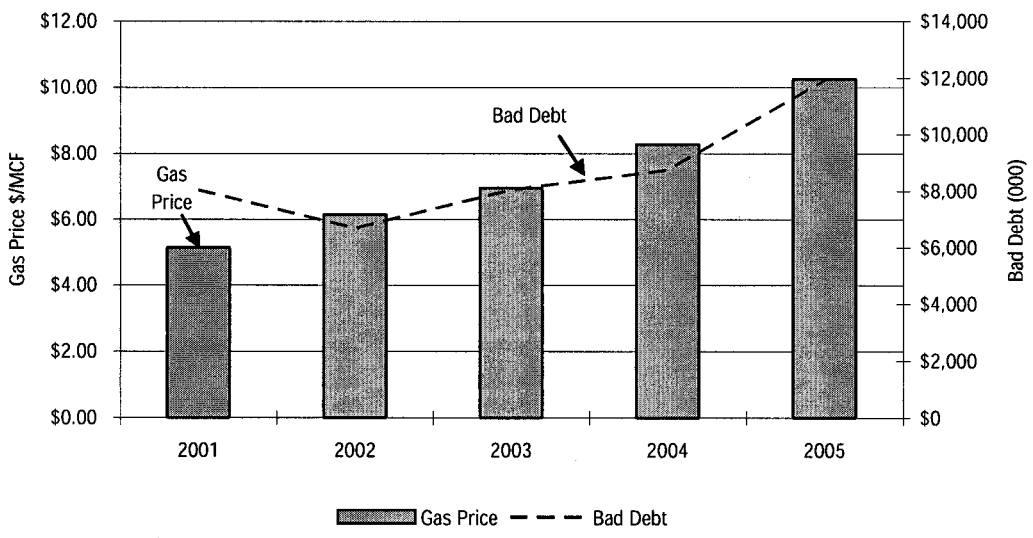
the argument for incorporating a conservation protection design. For example, Questar Gas Company believes that earning its authorized return has been very difficult due to the combination of declining average consumption over time, the use of a historical test year in general rate cases, and the fact that most of its fixed-non-fuel costs are recovered through a volumetric charge. The upshot has been revenues that in normal weather years have fallen short of their own non-gas costs---because average-customer sales in the rate-effective years fell short of the (historical) test-year figures that were used to set rates. Questar would like to decouple its non-gas revenues from year-to-year movements in the per-customer average consumption levels. The mechanics of the decoupling would employ a balancing account to recover non-gas related revenues lost/gained when average consumption drops/rises above the projected average.[1]

In attempting to grapple with the conservation issue, LDCs are in fact, having to dispel the notion that their fixed charges should be recovered from volumetric sales of gas. As the fixed charges appear year in and year out regardless of gas usage, the volumetric approach to cost recovery for operating a gas distribution system is a faulty equation which needs to be rectified in ratemaking. It would appear therefore, that unless and until this anomaly is corrected, the LDC would lack the necessary tools with which to earn its allowed rate of return.

Bad Debt Expense and Increases in Working Capital

One consequence of rising natural gas prices purchased by LDCs and passed onto their customers is the higher level of bad debt expense and increases in working capital that these companies must now contend with. In the winter of 2005 for example, one LDC reported a doubling of their bad debt expense which increased by an average of 17% for all respondents. LDCs in some states such as those located in North Carolina, had the good fortune of being able to recover the gas component of bad debt expense through their purchase gas adjustment (PGA) mechanism, thereby reducing the level of bad debt expense that the company had to absorb on their own. Fig. 3 depicts the close correlation between rising average bad debt expenses and rising gas prices.

Figure 3
Gas Price vs. Bad Debt

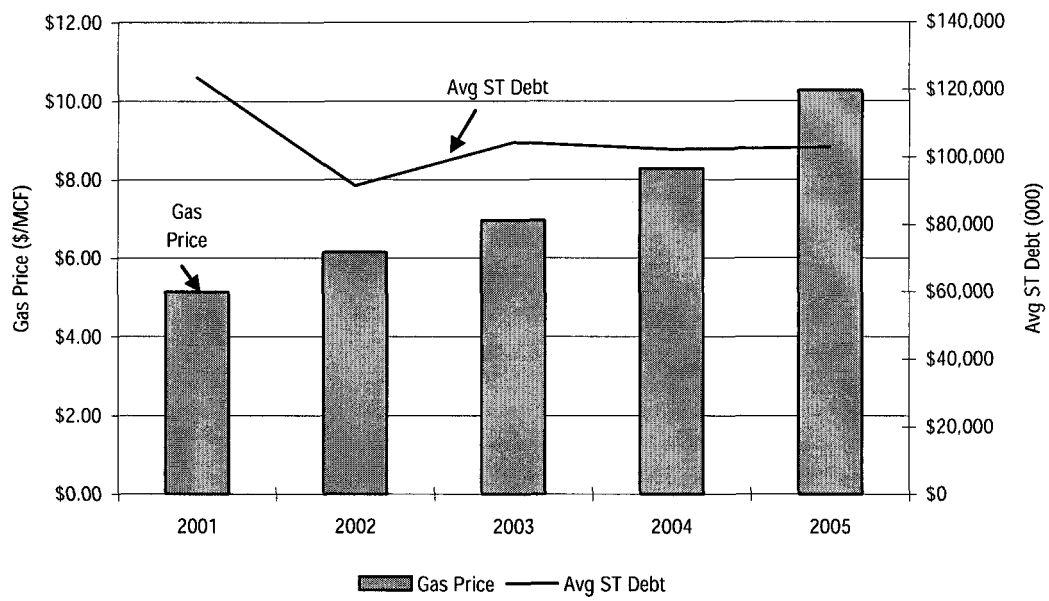


1. *Prefiled Direct Testimony of George R. Compton, Ph.D., for the Division of Public Utilities of the Utah Department of Commerce, Before the Public Service Commission of Utah, January 23, 2006, Docket No. 05-057-T01*

As one would expect, with the higher level of gas commodity prices that customers had to pay and the rise in bad debt expense experienced during the past three winter heating seasons, most LDCs incurred higher levels of working capital. The winter of 2005 witnessed one of the sharpest increases in seasonal working capital on account of accounts receivables and inventory build-ups related to higher natural gas prices, rising 136% over 2004 levels among those LDCs responding to affirmative increases in working capital levels. One large LDC reported a 185% increase in their 2005 working capital level over the prior year. Some companies however, were able to match their increases in accounts receivables and inventory with accounts payable by structuring their gas purchase transactions to more closely match their gas payments for inventory and timing these closer to the anticipated cash receipts from customers, so that they had less working capital to finance.

It is also interesting to note, as depicted in Fig. 4, that on average, LDC short term debt remained relatively flat after 2003 despite the continuing rise in the cost of natural gas prices. Some companies indicated that they were deliberately refinancing short-term debt through medium term notes or through other means of long-term debt by locking in the cost of financing under favorable interest rates, while others were able to contain the increases in their 2005 working capital levels and did not need to borrow as much for their seasonal needs. In fact, approximately half the LDCs indicating having higher levels of working capital in 2005 compared with prior years were able to reduce their short-term debt levels by refinancing via long-term debt or issuance of new equity.

Figure 4
Gas Price Vs. Avg Short Term Debt Outstanding



LDCs Take Varied Approaches in Integrating WNC with RD

It appears that LDCs that already have full RD similar to the "balancing accounts" including revenue normalization adjustments or customer utilization trackers being employed in certain jurisdictions such as California, Maryland and North Carolina, prefer to keep their rate designs intact as they are easily administered and allow for full recovery of their authorized margins. Most other companies that currently have WNC in some of their jurisdictions however, prefer to keep the conservation margin tracker or tariff separate, for the reason that their current WNC provide real time cash flow and earnings adjustments whereas the conservation trackers typically provide after-the-fact cash flow adjustments through deferral accounts that are collected over a subsequent 12-month period.

While some public utility commissions would permit the filing of RD outside the procedural norm of a full rate case, most would clearly prefer a full rate case to be filed in connection with a rate design alteration or at least to review a general rate case after-the-fact in short order. It also appears that the great majority of respondents experiencing customer gas consumption declines on account of conservation would be inclined to file and re-file for some form of RD if denied the first time by their regulators. For many, this is a long but necessary trek to take as a means of curing a rate design deficiency that appears to be increasingly untenable.

Conclusion

In our comment last year, we mentioned several LDCs that had the ability to correct for margin losses on account of conservation or weather variables through their rate design mechanisms, or had RD filing plans or extension plans. Among these, Alabama Gas Corporation (Alagasco) advises that their "rate stabilization and equalization" mechanism will continue through at least 2008 and Southern California Gas Company (SoCal Gas) appears to be satisfied with how their "balancing accounts" have been implemented previously and have requested that the regulatory commission continue with them going forward. Following the completion of an independent study to measure the effectiveness of its conservation mechanism, Northwest Natural Gas Company was able to obtain approval of the Oregon Public Utility Commission in 2005 to continue its conservation tariff for an additional four years through September 30, 2009, and increase the mechanism's coverage from a partial decoupling of 90% of residential and commercial gas usage to a full decoupling of 100%. It also maintains a separate weather normalization mechanism that was extended through September 2008.

In April of 2006, Cascade Natural Gas Corporation in Washington State obtained approval from the Oregon Public Utility Commission to implement a decoupling mechanism to track changes in margin due to conservation (variations in weather-normalized usage) and to track changes in margin due to weather variations from normal for residential and commercial customers. Cascade's RD application for Washington State is still pending.

Piedmont Natural Gas in North Carolina obtained approval for a full RD mechanism for a three-year trial period, with the state's Attorney General appealing the decision in the courts. The appeal has been initiated and the court has taken no action. In the meantime, the company has implemented the mechanism effective November 1 of 2005.

Washington Gas Light Company obtained a full RD (Revenue Normalization Adjustment) in its Maryland jurisdiction which went into effect on October 1, 2005. It has previously attempted to introduce at least partial RD in its Virginia and Washington D.C. jurisdictions.

Southwest Gas Corporation did not fare as well in its Arizona RD application where it generates 54% of its gross margin. The company's credit metrics were already weaker than its Baa utility peers and it badly needed an effective RD mechanism across all its jurisdictions to protect its gross margins. While the Arizona Corporation Commission finally granted it a partial rate increase after over one-year in the application process and brought current recent cost and customer usage factors in Arizona, it denied the company its request for RD through "balancing accounts" as it has in California. The company also lacks RD in its Nevada jurisdiction (37% of gross margins) and the company lost gross margins in 2005 when it experienced one of the 10 warmest years on record, which followed a warm 2003, one of the warmest years in over 100 years. The cumulative effects of this warmer than normal weather continued into the company's quarter ending March 31, 2006 which was mostly responsible for the company's loss of $9 million in operating margin. Moody's took action in May 2006 to downgrade the company's senior unsecured debt to Baa3 from Baa2 where it is currently under stable outlook.

In the meantime, the list of LDCs applying for RD continues to expand with Atmos Energy Corporation attempting to add conservation riders in key jurisdictions where it already has WNC, Indiana Gas Company and Southern Indiana Gas and Electric Company (utility subsidiaries of Vectren Utility Holdings) both applying for conservation margin protection in Indiana to supplement their recently approved WNC, and Questar Gas Corporation seeking a conservation tariff in Utah. New Jersey Natural Gas and South Jersey Gas Company filed for a joint RD application in New Jersey, requesting a full decoupling mechanism. Both of these New Jersey utilities already have WNC.

Moody's believes that the LDCs successful in their RD initiatives will stand a better chance than others in protecting their gross margins and overall credit metrics from the negative impacts of increasing volatility of natural gas prices and climatic changes. Stronger margins and earnings would also serve to cushion the blows inflicted by increases in bad debt expense that tend to accompany rising gas prices. As gas customers step up their conservation efforts in response to these rising commodity prices, it will become increasingly important for LDCs to switch from a gas volumetric cost recovery methodology to one of RD. While RD may have originally begun as a regional concept in certain jurisdictions, it has quickly become a nationwide phenomenon that will challenge regulators and gas utilities alike, as they seek to correct a structural imbalance in their rate design that has become increasingly difficult to ignore.

Related Research

Special Comments:

Impact of Conservation on Gas Margins and Financial Stability in the Gas LDC Sector, June 2005 (92798)

Comparative ROE Attributes of US Local Gas Distribution Companies, July 2004 (87301)

Negative Rating Trend for Local Gas Distribution Companies: Impact of Diversifications and Warm Weather, October 2002 (76344)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MIKE GLEASON- CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASE GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

Rejoinder Testimony of

Dallas J. Dukes

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

TABLE OF CONTENTS

I. Introduction

II. Rebuttal to Staff Witness Ralph Smith 1

A. Construction Work In Progress (Staff Adjustment B-1) 1

B. Geographic Information System ("GIS") (Staff Adjustments B-2 & C-5) 3

C. Incentive Compensation (Staff Adjustment C-6) 4

1. Performance Enhancement Plan ("PPE") 4

2. Officer's Long Term Incentive Program 6

3. Supplemental Executive Retirement Plan 8

D. FERC Rate Case Legal Expense (Staff Adjustment C-11) 8

E. Rate Case Expense (Staff Adjustment C-19) 9

III. Rebuttal to Staff Witness Julie McNeely Kirwan 11

A. CARES Program Deferred Balance Amortization (Staff Adjustment C-20) 11

IV. Rebuttal to RUCO Marylee Diaz Cortez 12

A. GIS Expenditures (RUCO Rate Base Adjustment 5 & Income Statement Adjustment 12) 12

B. Out-of-Period Expenses (RUCO Income Statement Adjustment 19) 14

C. Legal Expenses (RUCO Income Statement Adjustment 20) 14

V. Rebuttal to RUCO Witness Rodney L. Moore 14

A. Incentive Compensation (RUCO Income Statement Adjustment 2) 14

B. Customer Service Costs (RUCO Income Adjustment 5) 15

C. Unnecessary Expenses (RUCO Income Statement Adjustment 6) 17

D. Rate Case Expense (RUCO Income Statement Adjustment 8) 18

E. SERP (RUCO Income Statement Adjustment 11) 18

Exhibits Invoices

I. INTRODUCTION.

Q. Please state your name and business address.

A. My name is Dallas J. Dukes and my business address is One South Church Avenue, Tucson, Arizona 85702

Q. Are you the same Dallas J. Dukes that filed file Direct Testimony and Rebuttal Testimony in this case?

A. Yes.

Q. Mr. Dukes, have you reviewed the Surrebuttal Testimony filed by the Commission Staff and Intervenors in this case?

A. Yes, I have.

II. REJOINDER TO STAFF WITNESS RALPH SMITH.

A. Construction Work in Progress (Staff Adjustment B-1).

Q. Mr. Dukes do you have any comments regarding Mr. Smith's recommendation to exclude CWIP from rate base?

A. Yes. I do. Specifically, I would like to address Mr. Smith's arguments against the removal of approximately $4.158 million of customer advances from rate base, if CWIP is excluded from rate base. Mr. Smith spends several pages arguing that the inclusion of CWIP in rate base causes a mismatch in the ratemaking process. At page 12, lines 14-15, of his Surrebuttal Testimony, he states "Hence, including the investment in rate base, without recognizing the incremental revenue it supports, would be imbalanced." And at page 12, lines 19-20, he states "In other words, allowance of CWIP in rate base would result in a

mismatch in the ratemaking process." However, these same arguments are not considered when Mr. Smith addresses the requested removal of customer advances specifically associated with projects not included in rate base.

Q. Why should Mr. Smith consider it a mismatch or an imbalance to reduce rate base by the entire balance of customer advances at the end of the test year?

A. Because $4.158 million of those advances is related to capital projects included in the CWIP balance that Mr. Smith is arguing to exclude from rate base. If CWIP is excluded from rate base, then the related customer advances should not be a reduction of rate base; otherwise the Company is penalized. In this particular case, the Company in effect would be denied a return on $4.158 million of its own investment based on the false assumption that the Company has that amount in cost free capital available at the end of the test year. In reality, those funds have already been spent on the specific projects they were intended for and exist as CWIP.

Q. What about Mr. Smith's assertion that customer advances represent non-investor supplied capital?

A. I agree with Mr. Smith that customer advances represent non-investor supplied capital. But I do not agree that the Company should be unfairly penalized by the treatment of such in a rate case. To the extent advances have been received by the Company and not yet spent, those funds constitute zero cost capital and should be recognized as a reduction of rate base. To the extent that an advance has been spent on a capital project that is in rate base it should be reflected as a reduction of rate base. This treatment protects customers from paying a return on non-investor supplied capital. But, if the advance is related to a capital project not yet in service (and therefore, not yet in rate base) as of the end of the test year and the funds have already been spent, it is not fair to reduce the Company's rate base for that portion. By doing that, the Company is denied a return on a portion of its actual

investment.

Q. What about Mr. Smith's statement that the Commission's rules require that customer advances be reflected as a deduction from rate base?

A. Mr. Smith refers to the requirements for Schedule B-1 in the Commission rules (A.A.C. R14-2-103, Appendix B, Schedule B-1). However, I would like to point out that nowhere in the Commission rules does it explicitly state that 100% of the balance of advances must be excluded from rate base. I believe the intent of the rule is to insure that customers do not pay a return on non-investor provided capital.

I would also like to point out that the rules also require the exclusion of contributions in aid of construction. But, a contribution made to a natural gas company is properly accounted for as a credit (reduction) to the specific "work order" it is received to fund; there is no specific FERC account for contributions as a contra to plant in service. The contribution is a credit to the work order. When that work order is in the construction phase or accruing in CWIP on the balance sheet, then the contribution is also still in CWIP. Then when the work order is put into service the asset is moved to plant in service at the net amount. I believe that is more consistent with the Company's proposed treatment of customer advances and represents the fair treatment of contributions and advances.

B. <u>Geographic Information System ("GIS") (Staff Adjustments B-2 & C-5).</u>

Q. Mr. Dukes will you please summarize Mr. Smith's primary reasons for his recommendation to deny the Company recovery of GIS expenditures?

A. Yes. Mr. Smith argues that the Company did not request an accounting order at the appropriate time, that the expenditures are non-recurring and primarily prior period expenses, and that the expenditures for GIS are not significantly different than all other

expenses incurred by the Company to serve its customers.

Q. Do you have any comments on Mr. Smith's recommendation?

A. Yes. The Company is not arguing that the expenditures are not properly accounted for as expenses or that the Company should have requested an accounting order prior to beginning the project. But the Company is requesting that the Commission look at the entire situation and allows the Company a reasonable opportunity to recover the GIS expenditures, which are used and useful, serving customers and are the result of the Commission's Pipeline Safety audit.

Q. Can you expand your explanation of what the Company is requesting?

A. Yes. The GIS expenditures were incurred in response to a directive from the Commission's Pipeline Safety Section. The Company understands that it should have requested an accounting order at the proper time because the expenditures were originally misclassified. But had the Company identified the GIS cost as an expense prior to beginning the project, it would have requested an accounting order. The magnitude of the expense and the fact that it is not reflected in the current rate structure would have compelled the Company to request deferral or seek an alternative approach to meeting the Commission's directive. The Company is just asking for a fair review of its request and an opportunity to recover expenditures made to correct an inadequacy inherited from the previous owner and directed by the Commission.

C. <u>Incentive Compensation (Staff Adjustment C-6).</u>

1. **Performance Enhancement Plan ("PEP").**

Q. Mr. Dukes would you briefly summarize Mr. Smith's position regarding the Company's PEP expenses.

A. Yes. Mr. Smith contends that the Company's PEP program is essentially the same as the Southwest Gas Corporation ("SWG") Management Incentive program and thus should be treated the same for ratemaking purposes.

Q. Do you agree with Mr. Smith's position?

A. No, I do not. Mr. Smith has failed to demonstrate comparability between UNS Gas' and SWG's incentive programs and overall compensation circumstances. He simply states that based on the information provided he does not see any meaningful distinction in the incentive compensation programs, but does not provide any evidence to support this assertion. I respect that prior rulings can provide guidance on issues and may set a precedent, but I see no evidence presented by Mr. Smith to show that UNS Gas' compensation levels or incentive programs are almost identical to those of SWG.

The UNS Gas PEP program is part of a fair and reasonable compensation program that is benchmarked at the median compensation levels by job classification. As I described at great length in my Rebuttal Testimony, all non-union employees are a part of the PEP program and thus have a portion of their pay put at risk, which produces overall lower compensation cost as compared to paying median compensation through base wages entirely.

Q. Mr. Smith questions the "at risk" feature in his Surrebuttal Testimony. Do you have a comment?

A. Yes. Mr. Smith implies that because the Board awarded a payout in 2005 despite missing

the PEP's financial target that perhaps the "at risk" feature is not in practice.

First, that belief ignores the fact that payouts are awarded on an individual basis based on merit and individual employees are not guaranteed any of the 42% payout. Some employees could have received more than 100% and some may have received 0%. That is a feature that make it a valuable management tool to reward individual performance and puts the pay "at risk" for individual employees.

Second, the amount can vary any year from 50% to 150% based on the different goals of the program. That in and of itself puts part of the PEP payout at risk. I understand that Mr. Smith, at the time of preparing his Surrebuttal Testimony, had not had time to examine the bench mark study that I referenced in my Rebuttal Testimony. Had he had time to analyze it, he would have seen that UNS Gas employees trail the median of market by 26% for Target Total Cash (base wages plus target annual compensation). And as I pointed out in my Rebuttal Testimony, UNS Gas employees trail the median of market by 8% for Total Cash (base wages plus actual annual incentives). Also, as I stated in my Rebuttal Testimony, 79% of companies provide lump sum cash awards. Those are real factors in being able to attract and retain employees, while controlling costs for UNS Gas.

2. <u>Officer's Long Term Incentive Program</u>.

Q. Did Mr. Smith address the Officer's Long Term Incentive Program in his Surrebuttal Testimony?

A. Mr. Smith stated that he had not had an opportunity to review the Company's most recent data responses on the subject yet and will make recommendations at a later date.

Q. Did Mr. Smith address Officer's Long Term Incentive Program in his Surrebuttal Testimony?

A. Yes. He reduced the test year expense by 50% based on the premise of equal sharing between customers and shareholders.

Q. Mr. Dukes, do you still disagree with Mr. Smith's proposed elimination of 50% of the test year long term incentive expense allocated to UNS Gas?

A. Yes, I still disagree with his proposal.

Q. Do you have any changes to your Rebuttal Testimony you would like to address?

A. Yes. I would like to make a few small changes. At page 11 of my Rebuttal Testimony:

- Line 4, should read, "The Board has set that target at approximately the median of a peer group of"; Line 9, should read, "target compensation levels, and to compare them to a peer group. The last study performed in October 2005"; Line 10, should read, "showed that TEP's Executives' total compensation program target (including incentive"; and Line 11, should read, "programs) was 5% below the 75% mark of the peer group."

Q. Are there any additional comments you would like to make about the Officer's Long Term Incentive Program?

A. Yes. I would like to just further clarify that the "target" compensation level was at approximately 70% of market in the most recent study, not actual compensation. "Target" assumes incentive compensation at full payouts. The actual 2005 Officer Total Direct Compensation was below the median of the peer group from the 2005 Executive Compensation Review. So the executive compensation that was the basis for allocations to UNS Gas during the test year was actually below the median level of the peer group, and the peer group data was obtained from 2004 Proxy statements.

3. Supplemental Executive Retirement Plan.

Q. Did Mr. Smith address the Supplemental Executive Retirement Plan in his Surrebuttal Testimony?

A. Yes. Mr. Smith again compares UNS Gas' compensation programs to SWG without providing any evidence to support the comparison. I agree that the SERP programs may be similar. However, the SERP program is just a portion of executive compensation allocated to UNS Gas from TEP and I do not believe it should be judged in isolation. I also do not believe it is fair to compare it to SWG's SERP program without putting it into the context of the entire executive compensation program. As I stated above, the actual 2005 Officer Total Direct Compensation was below the median of the peer group from the 2005 Executive Compensation Review.

Q. Are there any additional comments you would like to make about the Supplemental Executive Retirement Plan?

A. Yes. I would just like to reiterate why a program like SERP is necessary. First, it is a program offered by every company in the peer group used to evaluate executive compensation. Second, it is standard offering in executive compensation programs. Third, the Internal Revenue Code dictates funding limits for tax deductibility, but as I said in my Rebuttal Testimony that is based on collecting tax revenues and does not mean that it should be the cap for fair and reasonable retirement benefits.

D. FERC Rate Case Legal Expense (Staff Adjustment C-11).

Q. Did Mr. Smith address the FERC Rate Case Legal Expense in his Surrebuttal Testimony?

A. Yes. Mr. Smith summarized the proposal in my Rebuttal Testimony to average 2004-2005

and did not make any changes to Staff's original recommendation to reduce test year legal expenses by $311,051.

Q. Do you have any additional comments?

A. Yes. The Company provided the legal expenses for 2006 of $425,541 as support for the two-year average. It also provided information that the Company had incurred $70,868 in legal expenses as of the end of February 2007; which would annualize to $425,208. I recognize that annualizing two months of data for 2007 is not necessarily a reliable indicator, but it is indicative of the Company's position that recurring legal expenses will be in the $400,000 range for the foreseeable future.

E. <u>Rate Case Expense (Staff Adjustment C-19)</u>.

Q. Mr. Dukes would you briefly summarize Mr. Smith's position regarding rate case expense.

A. Mr. Smith did not propose any adjustment to the Company's rate case expense in his Direct Testimony. However, in his Surrebuttal Testimony Mr. Smith adopted the approach by RUCO's witness Mr. Rodney Moore. This approach basically assumes that UNS Gas is equivalent to SWG and its rate case expense should be equivalent as well.

Q. Is it a fair assumption that UNS Gas and SWG are similar and that their rate case expenses should be similar?

A. Absolutely not. In my Rebuttal Testimony, I went into considerable detail to explain why it is not appropriate to compare the two companies in this particular area. I explained the differences in how each company allocated shared services cost, SWG from corporate as an indirect allocation based on a Massachusetts formula, and UNS Gas as a direct charge by a separate regulated utility based on actual usage. Basically, Staff and RUCO are

recommending that the services provided by the personnel of TEP, a separate regulated utility, should be provided at no cost to UNS Gas customers. Their recommendation contradicts my understanding of how affiliated charges between two regulated utilities should be handled. It is not proper for TEP personnel to provide service to UNS Gas and not charge UNS Gas. And if UNS Gas is charged for incremental costs incurred as a result of a regulatory proceeding, then it is inappropriate to deny UNS Gas recovery of these costs.

Q. What would be the impact on the revenue requirement of UNS Gas if TEP were to indirectly allocate its shared services cost to UNS Gas in a similar manner as SWG?

A. As I discussed in my Rebuttal Testimony, SWG uses a Massachusetts formula to indirectly allocate its corporate overhead and shared services cost to its Arizona operations. But, UNS Gas is only indirectly allocated Executive department cost and general corporate overhead that indirectly benefits all UniSource companies.

For shared services cost, like accounting, legal and pricing, UNS Gas is directly charged costs from TEP only for the hours actually provided by TEP employees on their behalf. If you were to indirectly allocate TEP's shared services cost to UNS Gas using a Massachusetts formula, the annual cost would increase by approximately $2.5 million. That is derived by taking the TEP shared service cost in total for the test year of $47.5 million and allocating 9.42 % to UNS Gas ($4.5 million) less the current amount directly charged to UNS Gas of approximately $2 million. Obviously, that $47.5 million would be subject to audit by Staff and RUCO and some adjustments might be found, but it is unlikely that it would have a significant impact on the final amount allocated to UNS Gas.

That is precisely why SWG's rate case expense is so much lower than UNS Gas'. UNS Gas has no internal staff to pull together and litigate this rate case, and unlike SWG it is not

indirectly allocated cost for the departments that provide that service. The UNS Gas test year includes only the cost directly allocated from TEP shared service departments for normal and recurring activities, excluding rate case activities. SWG is recovering corporate shared service cost as part of base rates and it would be double recovery to also allow them to recover those same costs through rate case expense. Their rate case expense is essentially an outside consultant or two. UNS Gas' rate case support is being provided almost entirely by a separate a regulated affiliate and the costs are incremental to the service costs routinely billed to UNS Gas by that same regulated affiliate.

III. REJOINDER TO STAFF WITNESS JULIE MCNEELY KIRWAN.

A. CARES Program Deferred Balance Amortization (Staff Adjustment C-20).

Q. What is Staff proposing for Cares Program cost?

A. Staff is recommending that UNS Gas be ordered to cease deferral of CARES program costs and a different discount amount and rate design than UNS Gas is requesting. UNS Gas witness Mr. Erdwurm will address our concerns over Staff's recommendation on the CARES discount and how it should be addressed in rate design. I would like to address the suggestion to cease the deferral accounting.

Q. What are your concerns over Staff's recommendation and what is your recommendation?

A. The current structure insures that the Company is made whole for discounts given and that the customers are not providing additional revenues to the Company. It also provides a simple and transparent way for the Commission to monitor the program. This is consistent with the direction in which all parties are heading for DSM and Renewables costs, which allows the Commission to easily see how much money was collected and spent. I

recommend that UNS Gas continue the deferral accounting and thus insure that the customers and the Company are kept whole.

Q. Do you have any other concerns with Ms. McNeely-Kirwan's recommendation?

A. Yes. Ms. McNeely-Kirwan states in her Surrebuttal Testimony that the CARES discount being proposed by Staff is being addressed in rate design and therefore it is not necessary to include the discount as part of operating expenses. Given her proposal to discontinue the deferral accounting, that is the more proper way of reflecting the discount; as a reduction in rates. However, in reviewing Staff's attachment RCS-S1R, Schedule RD-1, page 2 of 2, which is a presentation of Staff's proposed rates, they do not show the volumetric rate for Residential Service CARES (R12) at the discounted level. By doing this, they are inadvertently inflating the revenues that will be collected from that class.

IV. REJOINDER TO RUCO WITNESS MARYLEE DIAZ CORTEZ.

A. GIS Expenditures (RUCO Rate Base Adjustment 5 & Income Statement Adjustment 12).

Q. Do you have any comments regarding Ms. Diaz Cortez's proposal that the Company not be allowed to recover the GIS expenditures?

A. Yes. Ms. Diaz Cortez has made essentially the same arguments as Staff witness Mr. Smith and I addressed those arguments in my Rebuttal Testimony and earlier in my rejoinder Testimony. However, Ms Diaz Cortez continues to claim that because the revenues of the test year were greater than the expenses of the test year, including the GIS expenditures, and because the Company had a positive operating income then the GIS expenditures were therefore recovered. That position completely ignores the fact that operating income of the Company is meant to provide a reasonable return on shareholders investment. When an

expense like the GIS is incurred that is not contemplated in the current rate structure, I would argue that it is the Shareholders' return that is essentially reduced.

Q. Isn't it true that costs not contemplated in current rates routinely occur between rate cases and that it could even be in the form of cost reductions?

A. Yes. And sometimes Shareholders benefit from cost reductions between rate cases. However, the vast majority of the time costs increase, which is UNS Gas' circumstance and it is the shareholders' return that is decreased.

Q. Why should these costs be considered any differently than other cost increases and cost reductions between rate cases?

A. These costs should be treated differently because there has always been consideration given to the magnitude of expense changes and the reason for the expense change. In the case of Y-2K costs, many Commissions, including Arizona, allowed companies to defer the costs and to recover them later because of the reasons causing the expenses to be incurred and because of the magnitude of the expense. Often, when companies have been required to implement new accounting pronouncements, those companies were allowed to defer and recover the recognition of prior cost and recover those cost over future years as they transitioned to the new method. As I stated earlier in my testimony, the Company is looking for fair consideration and recovery of these very significant costs incurred to meet a Commission directive despite the fact that the Company failed to request an Accounting Order in a timely manner because of its own inadvertent original misclassification.

B. **Out-of-Period Expenses (RUCO Income Statement Adjustment 19).**

Q. Has Ms. Diaz Cortez addressed her adjustment for out-of-period expenses in her Surrebuttal testimony?

A. Yes. Ms. Diaz Cortez summarizes the Company's Rebuttal Testimony that pointed out that there were invoices supporting services provided in 2005 but paid in 2006 that more than offset the invoice she proposed to exclude (for invoices paid in 2005 for services provided in 2004). However, Ms. Diaz Cortez did not alter her adjustment because the Company did not provide these invoices as part of the rebuttal filing. Therefore, the Company is providing copies of the invoices as attachment Exhibit DJD-2, to this filing.

C. **Legal Expenses (RUCO Income Statement Adjustment 20).**

Q. Has Ms. Diaz Cortez addressed her adjustment for legal expenses in her Surrebuttal testimony?

A. Yes. Ms. Diaz Cortez continues to assert that the level of recurring legal expense she is providing for within RUCO's proposed revenue requirement for UNS Gas is adequate. I have addressed this in my earlier rejoinder testimony of Staff's witness Mr. Smith and strongly disagree with this position.

V. REJOINDER TO RUCO WITNESS RODNEY L. MOORE.

A. **Incentive Compensation (RUCO Income Statement Adjustment 2).**

Q. Has Mr. Moore addressed his adjustment for incentive compensation in his Surrebuttal testimony?

A. Yes. Mr. Moore continues to defend his position of eliminating incentive compensation

expense from the test year.

Q. Do you have any additional comments about Mr. Moore's position?

A. Yes. I have addressed Mr. Moore's arguments previously in my Rebuttal Testimony, and earlier in my Rejoinder Testimony above. However, I would like to address two of his points. First, Mr. Moore is arguing against the use of an historical average to arrive at an adequate recurring level of incentive compensation expense based on strict adherence to the "Historical Test-Year Principal", yet at the same time he is arguing to also exclude the test-year expense awarded as incentive compensation. That appears to be taking contradictory positions within one adjustment. Second, Mr. Moore continues to argue that the entire program is flawed because it only rewards a segment of the employee base. I find this argument very puzzling. It implies that part of the workforce cannot have an impact on results, which is entirely incorrect and it implies that even if a program can be shown as cost effective and as producing results, if it does not apply to the entire workforce, then it should not be used. This does not seem like a sound business practice. As I have testified earlier, UNS Gas would like to make the PEP program a part of every employees' compensation program, but has been unable to do so with the Union workforce. However, that shouldn't mean that the program should be abandoned. The program still provides all of the benefits I testified about earlier and impacts customer service and customer cost.

B. <u>Customer Service Costs (RUCO Income Adjustment 5).</u>

Q. Has Mr. Moore addressed his adjustment for customer service costs in his Surrebuttal testimony?

A. Yes. Mr. Moore continues to defend the disallowance of the cost associated with the customer service call center activity being provided by TEP.

Q. Do you have any additional comments about Mr. Moore's position?

A. Yes. Mr. Moore attempts to tie an increase in the number of complaints filed against "UNS" to an increased level of dissatisfaction with the services provided by the TEP call center. First, I cannot verify Mr. Moore's complaint numbers. Our records indicate 120 UNS Gas complaints in 2005 and 149 in 2006. Secondly, the primary driver in customer call volumes in 2005 and 2006 (352,330 and 483,026 respectively) is a result of significantly increased gas cost, more specifically the surcharges to reduce the purchased gas bank. Third, the previous system could not even have handled the call volume in 2006. And whenever call volumes dramatically increase it stands to reason that the chance for customer dissatisfaction with the process will increase. If a customer doesn't call or contact the gas company it is extremely unlikely they will call the Commission and complain about customer service. However, if a customer sees that gas prices are rapidly increasing and calls the gas company and then decides they are dissatisfied with the response in some way it is obviously much more likely they may call the Commission to complain. Now that particular customer is most likely not upset at how his or her interaction with the call center employee was handled, they are most likely upset with their perception of a lack of resolution to their individual problem. Which in the case of increased gas cost, a call center representative is not likely able to fully resolve that customers underlying dissatisfaction. Finally, Mr. Moore's arguments still blatantly ignore that the system in place prior to the conversion to using TEP's call center would have to have been significantly altered, including increased staffing, increased phone lines, increased hardware and software and increased supervisor positions to meet the call level and service demands currently being handled by TEP for UNS Gas.

C. <u>Unnecessary Expenses (RUCO Income Statement Adjustment 6)</u>.

Q. Has Mr. Moore addressed his adjustment for unnecessary expenses in his Surrebuttal testimony?

A. Yes. Mr. Moore continues to defend the disallowance of all of approximately 2,000 separate charges that he identified based basically on vendor description.

Q. Do you have any additional comments about Mr. Moore's position?

A. Yes. Mr. Moore makes a statement to the effect that the Company padded the historical test year with unnecessary purchases worth over $200,000. The transactions he is referring to have been discussed by Company's witness Gary Smith, and he has explained why those charges were incurred. The Company by no means is trying to create a "warm and fuzzy" feeling; the Company is obligated to account for expenses appropriately and makes every attempt to do so. Of course there is the potential for mistakes in classification or charges above-the-line that should be below-the-line. The Company is not claiming that it keeps perfect records - no Company does. It would absolutely cost the Company and thus customers too much to treat every transaction individually and to make sure every debit and every credit is accounted for 100% correctly.

However, the Company strongly disagrees with any assertion that it has padded the test year. On the contrary, I believe that RUCO has padded its adjustment by forcing the Company into a choice to provide detailed support for thousands of immaterial transactions or lose recovery of the inflated aggregate. The situation is doubly unacceptable in that the Company would have to incur thousands of man-hours and thousands of dollars of rate case expense to refute RUCO's position and then in turn would likely have it argued that the additional rate case expense is unreasonable and a burden by the same RUCO witness.

D. Rate Case Expense (RUCO Income Statement Adjustment 8).

Q. Has Mr. Moore addressed his adjustment for rate case expense in his Surrebuttal testimony?

A. Yes. Mr. Moore continues to defend his proposed reduction of the Company's proposed rate case expense on the basis that the Company is essentially the same as SWG and its rate case expense should be similar.

Q. Do you have any additional comments about Mr. Moore's position?

A. Yes. I have addressed most of Mr. Moore's arguments in my earlier Rebuttal Testimony and in my rejoinder testimony of Staff's witness Mr. Ralph Smith. However, Mr. Moore continues to try to mischaracterize the situation. He uses SWG as a comparison while completely ignoring the difference in Company structures and the way in which corporate support services are provided and charged. He calls the charge a burden while ignoring the fact that the UNS Gas test year only contains shared service charges for services actually provided. UNS Gas' customers are not being burdened by paying the actual incremental cost for services being provided. As I testified earlier, if UNS Gas was indirectly allocated shared service cost from TEP it would increase the annual expense of UNS Gas by approximately $2.5 million. If that were the case, then Mr. Moore's comparison would be appropriate and reasonable.

E. SERP (RUCO Income Statement Adjustment 11).

Q. Has Mr. Moore addressed his adjustment for SERP expense in his Surrebuttal testimony?

A. Yes. Mr. Moore continues to defend his proposed elimination of SERP cost incurred by the Company during the test year.

Q. Do you have any additional comments about Mr. Moore's position?

A. Yes. I have addressed most of Mr. Moore's arguments in my earlier Rebuttal Testimony and Mr. Ralph Smith's arguments earlier in my Rejoinder Testimony. I continue to disagree with Mr. Moore's position.

Q. Does this conclude your Rejoinder Testimony?

A. Yes.

EXHIBIT

DJD-2

Exhibit DJD-2
Pages 1 of 6

PRICEWATERHOUSECOOPERS

January 05, 2006

Dave Grzybowski
Unisource Energy
3950 E. Irvington Road
Tucson, Arizona 85714
USA

CE982020
Release # 42

Invoice Number : 1030415524-4

INVOICE FOR SERVICES
PricewaterhouseCoopers LLP
P.O.Box 31001-0068
Pasadena, CA 91110-0068

Contract Number: 5000106690

December progress billing in connection with the 2005 Integrated Audit of UniSource Energy Copr for year ended 12-31-2005.	$	200,000.00
Out-of-Pocket-Expenses	$	9,098.00
Total Invoice	$	209,098.00

Includes { $ Jan 5 Invoice
40K UES audit

Over/Under BOD Budget $ 379,000 w/o expenses
Summary Sheet Entry by DSL Date 1-11-06
Accounting String for Payment
Project: CC00004 Task: CBU 0066 Exp: 151 CC: 305
Fin Acctg Review [illegible] Date 1/11/06
Approved for Payment [illegible] Date 1/11/06

If you have any questions please contact:
Steve Kitson (213)-356-6304
WBS: 0.0146322.001

Payment Due Upon Receipt

Tax Identification Number: 134008324

Exhibit DJD-2
Pages 2 of 6

PRICEWATERHOUSECOOPERS

January 23, 2006

Dave Grzybowski
Unisource Energy
3950 E. Irvington Road
Tucson, Arizona 85714
USA

Invoice Number : 1030427402-9

INVOICE FOR SERVICES
PricewaterhouseCoopers LLP
P.O.Box 31001-0068
Pasadena, CA 91110-0068

Release #45
PO CE982020

Contract Number: 5000106690

January progress billing in connection with the 2005 Integrated Audit of UniSource Energy Corp for year ended 12-31-2005.	$	150,000.00
Out of Pocket Expenses	$	20,650.00
Total Invoice	$	170,650.00

RECEIVED
ACCOUNTS PAYABLE
MAR 01 2006

Over/Under BOD Budget $ 229,000
Summary Sheet Entry by DSC Date 2-2-06
Accounting String for Payment Project CC00004
Task: CBU0066 Exp: 151 CC: 305
Fin Acctg Review [illegible] Date 2/2/06
Approved for Payment [illegible] Date 2/8/06

4m

If you have any questions please contact:
Steve Kitson 213-356-6304
WBS Code: 0.0146322.001

Payment Due Upon Receipt

Tax Identification Number: 134008324

Exhibit DJO-2
Pages 3 of 6

PRICEWATERHOUSECOOPERS

February 22, 2006

Dave Grzybowski
Dir., Financial Accounting & Report
UniSource Energy Corporation
3950 E. Irvington Road
Tucson, Arizona 85714
USA

P.O. CE982020

Release 46

Invoice Number : 1030451102-4

INVOICE FOR SERVICES
PricewaterhouseCoopers LLP
P.O.Box 31001-0068
Pasadena, CA 91110-0068

Contract Number: 5000106690

February progress billing in connection with the 2005 Integrated Audit of UniSource Energy Corp for year ended 12-31-2005.	$	100,000.00
Expenses	$	75,742.00
Total Invoice	$	175,742.00

RECEIVED
ACCOUNTS PAYABLE
MAR 06 2006

Over/Under BOD Budget ($ 129,000) w/o expenses
Summary Sheet Entry by [illegible] Date 2-27-06
Accounting String for Payment
TASK: CB40066 EXP: 151 CC: 305 Project: CC00004
Fin Acctg Review [illegible] Date 2/28/06
Approved for Payment [illegible] Date 3/1/06

Contact: Steve Kitson (213) 356-6304
WBS: 0.0146322.001

Payment Due Upon Receipt

Tax Identification Number: 134008324

Exhibit DJD-2
Pages 4 of 6

PRICEWATERHOUSECOOPERS

March 22, 2006

Dave Grzybowski
Dir., Financial Accounting & Report
Tucson Electric Power Co.
3950 E. Irvington Rd., OH 120
Tucson, Arizona 85714
USA

Invoice Number : 1030474166-2

INVOICE FOR SERVICES
PricewaterhouseCoopers LLP
P.O.Box 31001-0068
Pasadena, CA 91110-0068

PO. CE982020
Release # 49

Contract Number: 5000106690

March final billing in connection with the 2005 UniSource Energy Corporation's and Tucson Electric Power Company's FERC Form 1's	$	18,000.00
Total Invoice	$	18,000.00

Over/Under BOD Budget $(40,000) see attached
Summary Sheet Entry by NR Date 4-5-06
Accounting String for Payment
Project: CC0000 4 TASK: CBU006 Exp: 151 CC: 305
Fin Acctg Review [illegible] Date 4/5/06
Approved for Payment [illegible] Date 4/6/06

RECEIVED
ACCOUNTS PAYABLE
APR 10 2006

Contact: Steve Kitson 213-356-6304
WBS Code: 0.0172238.001

Payment Due Upon Receipt

Tax Identification Number: 134008324

Exhibit DJD-2
Pages 5 of 6

PRICEWATERHOUSECOOPERS

March 23, 2006

Dave Grzybowski
Dir., Financial Accounting & Report
UniSource Energy Corporation
3950 E. Irvington Road
Tucson, Arizona 85714
USA

Invoice Number : 1030474954-1

INVOICE FOR SERVICES
PricewaterhouseCoopers LLP
P.O.Box 31001-0068
Pasadena, CA 91110-0068

CE 982020
Release 47

Contract Number: 5000106690

March progress billing in connection with the 2005 Integrated Audit of UniSource Energy Corp for year ended 12-31-2005.	$	0.00
Out-of-Pocket Expenses	$	53,615.92
Total Invoice	$	53,615.92

Over/Under BOD Budget $ SEE NOTE BELOW
Summary Sheet Entry by DSC Date 3 29 2006
Accounting String for Payment
Project: CC 00004 Task: CBU0066 Exp: 151 CC: 305
Fin Acctg Review [illegible] Date 3/30/06
Approved for Payment KGL Date 4/6/06

NOTE: THE AUDIT COMMITTEE HAS APPROVED AN AUDIT FEE AMOUNT PLUS EXPENSES. AFTER PAYING THIS INVOICE, THE Y-T-D EXPENSES PAID IS $148,959.

RECEIVED
ACCOUNTS PAYABLE
APR 10 2006

Contact: Steve Kitson 213-356-6304
WBS Code: .0.146322.001

Payment Due Upon Receipt

Tax Identification Number: 134008324

Exhibit DJD-2
Pages 6 of 6

PRICEWATERHOUSECOOPERS

March 23, 2006

CE982020
Release: 48

Dave Grzybowski
Dir., Financial Accounting & Report
UniSource Energy Corporation
3950 E. Irvington Road
Tucson, Arizona 85714
USA

Invoice Number : 1030475131-5

INVOICE FOR SERVICES
PricewaterhouseCoopers LLP
P.O.Box 31001-0068
Pasadena, CA 91110-0068

Contract Number: 5000106690

Final supplemental billing in connection with the 2005 Integrated Audit of UniSource Energy Corp for year ended 12-31-2005.	$	175,000.00
Out-of-Pocket Expenses	$	0.00
Total Invoice	$	175,000.00

Over/Under BOD Budget ($ 58,000)
Summary Sheet Entry by DSC Date 3-29-2006
Accounting String for Payment
Project: CC00004 TASK: CBU0066 Exp: 151 CC: 305
Fin Acctg Review [illegible] Date 3/30/06
Approved for Payment KGK Date 4/6/06

RECEIVED
ACCOUNTS PAYABLE
APR 10 2006

Contact: Steve Kitson 213-356-6304
WBS Code: .0.146322.001

Payment Due Upon Receipt

Tax Identification Number: 134008324

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MIKE GLEASON- CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASE GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

Rejoinder Testimony of

Karen G. Kissinger

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

I. Introduction 1

II. Response to RUCO Surrebuttal Testimonies 1

Exhibit

Exhibit KGK-13 Narrative Portion of UNS Gas Response to RUCO Data Request No. 2.19

I. INTRODUCTION.

Q. Please state your name and address.

A. My name is Karen G. Kissinger. My business address is 4350 E. Irvington Road, Tucson, Arizona.

Q. Are you the same Karen Kissinger who filed both Direct and Rebuttal Testimony in this proceeding?

A. Yes, I am.

Q. Have you had an opportunity to read the Surrebuttal Testimony filed by the Commission Staff and RUCO witnesses regarding the topics you discussed in your Direct and Rebuttal Testimonies?

A. Yes I have.

II. RESPONSE TO RUCO SURREBUTTAL TESTIMONIES.

Q. Do you have any comments to Staff and/or RUCO Surrebuttal Testimonies?

A. Yes, with regards to RUCO Surrebuttal Testimonies. RUCO witnesses Ms. Diaz-Cortez and Mr. Moore do not fully address my Rebuttal Testimony, and provide no additional information with respect to the issues that I addressed. The assertions of unsupported plant additions and use of improper depreciation rates are conceptually flawed, and have not been correctly quantified in RUCO's recommended measure of UNS Gas revenue requirements.

Additionally, beginning at line 23 of page 5 of his Surrebuttal Testimony Mr. Moore states that both RUCO and the Company are in agreement with the amount $28,649,085 as

representing "the difference between the value of the Commission approved test-year gross plant in the prior rate case and the Company's requested amount in the instant case..". I wish to make it clear that there exists no such agreement. As pointed out in the narrative portion of our response to RUCO Data Request No. 2.19 (a copy of which accompanies this Rejoinder Testimony as Exhibit KGK-13) that $28.6 million amount can only be obtained by comparing the difference between gross recorded cost of plant in service acquired from Citizens on August 11, 2003 ($248,032,644) and the final adjusted plant in service at December 31, 2001 ($219,383,559) in the previous rate case. The actual recorded balance of plant in service at December 31, 2001 was $234,203,129. Thus, Mr. Moore is comparing a recorded gross plant balance at the end of 2001 after $14.8 million of adjustments with an unadjusted gross plant balance in August, 2003. These amounts are not comparable, and we do not agree with their use for any measurement purpose such as has been done by Mr. Moore.

Q Do you have anything to add to your Rebuttal Testimony regarding RUCO's assertions of unsupported plant additions and the use of improper depreciation rates.

A. No. I provided ample evidence through my Rebuttal Testimony *and* including several exhibits to show why RUCO's recommendation to disallow certain plant additions is completely without merit. Also, I showed how the Company's proposed depreciation rates were used by the Commission in determining and approving the revenue requirement for UNS Gas in Decision No. 66028 (July 3, 2003). RUCO provides no evidence that refutes either of these points.

Q. Does that conclude your Rejoinder Testimony?

A. Yes it does.

EXHIBIT

KGK-13

EXHIBIT KGK-13

UNS GAS, INC.'S SUPPLEMENTAL RESPONSE TO RUCO'S SECOND SET OF DATA REQUESTS DOCKET NO. G-04204A-06-0463

November 6, 2006

2.19 Net Gas Plant in Service – Further to the Company's response to RUCO data request 1.08, please provide the following additional information:

Specifically, RUCO has reconstructed the plant accounts between the authorized FVRB approved in the Settlement Agreement and the balances provided in the UNS response (see attached Schedules). This analysis shows that $28,649,085 in unsubstantiated plant additions occurred between 10/29/02 and 08/11/03.

Please make every effort to reconcile the increase of over $28.6 million of plant in ten months.

RESPONSE: UNS Gas is still compiling this information and the response will be provided at a later date.

RESPONDENT: Karen Kissinger

WITNESS: Karen Kissinger

SUPPLEMENTAL RESPONSE:

Information contained within the question appears to be incorrect, either with respect to the amount of the plant additions or the period during which such additions occurred. The plant additions amount appearing in the data request can only be arrived at by the following calculation:

Plant in Service Acquired at 8/11/03	$248,032,644
Adjusted Rate Base at 12/31/01 per the UNS Gas Rate Case and Acquisition Settlement agreement	219,383,559
	$ 28,649,085

UNS GAS, INC.'S SUPPLEMENTAL RESPONSE TO RUCO'S SECOND SET OF DATA REQUESTS DOCKET NO. G-04204A-06-0463

November 6, 2006

It should be noted that the numbers are not directly comparable. The rate base amount reflects the recorded Plant in Service balance at December 31, 2001 after being reduced by a net $14.8 million of rate case adjustments, while the acquired plant amount at August 11, 2003 has not been so adjusted.

In response to this request, four types of information are being transmitted herewith. The first is a reconciliation of the recorded Plant in Service balances at December 31, 2001 with the final adjusted amounts included in the rate case application and the settlement agreement approving the acquisition (see Bates Nos. UNSG(0463)00179 to UNSG(0463)00233).

The second is an analysis of the ending balances of Plant in Service and Construction Work in Progress as well as capital expenditures for each month during the period December 31, 2001 through August 11, 2003 (see Bates Nos. UNSG(0463)00234 to UNSG(0463)00243). Such reconciliation and analysis are derived from copies of the relevant pages from the monthly financial reports issued by Citizens Communications for its Northern Arizona and Santa Cruz Gas Divisions. These reports are the records of Citizens Communications, and not those of any UniSource Energy Corporation affiliate. It should be noted that the content of such monthly financial reports was substantially reduced after June 30, 2003; thus, the analysis does not reflect the Plant in Service nor CWIP balances at July 31, 2003 and August 11, 2003.

Third, we are attaching the audited financial statements for the Citizens Arizona Electric and Gas properties for the calendar year ended December 31, 2002 (see Bates Nos. UNSG(0463)00244 to UNSG(0463)00262). Bates Nos. UNSG(0463)00244 to UNSG(0463)00262 contain confidential information and are being provided pursuant to the terms of the Protective Agreement. In addition.

EXHIBIT KGK-13

UNS GAS, INC.'S SUPPLEMENTAL RESPONSE TO RUCO'S SECOND SET OF DATA REQUESTS DOCKET NO. G-04204A-06-0463

November 6, 2006

Fourth, balance sheet financial data files we received from Citizens Communications as of August 11, 2003 (see the four zip files on the enclosed CD) are provided. The four zip files on the CD are not identified by Bates numbers.

RESPONDENT: Carl Dabelstein

WITNESS: Karen Kissinger

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MIKE GLEASON- CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASE GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

Rejoinder Testimony of

Gary A. Smith

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

I. Introduction 1

II. Response to Ms. Diaz Cortez 2

III. Response to Mr. Moore 3

IV. Response to Ms. Scheier 4

V. Response to Mr. Magruder 6

I. INTRODUCTION.

Q. Please state your name and address.

A. My name is Gary A. Smith. My business address is 2901 West Shamrell Blvd., Suite 110 Flagstaff, Arizona 86001.

Q. Are you the same Gary Smith who filed Direct and Rebuttal Testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your rejoinder testimony in this proceeding?

A. The purpose of my testimony is to respond to certain comments made in the Surrebuttal Testimonies filed by Ms. Marylee Diaz Cortez and Mr. Rodney Moore on behalf of the Residential Utility Consumers Office ("RUCO"), Ms. Miquelle Scheier on behalf of the Arizona Community Action Association ("ACAA"), and Mr. Marshall Magruder. More specifically, I will respond to: (a) criticisms made by Ms. Diaz Cortez and Mr. Magruder concerning UNS Gas, Inc.'s ("UNS Gas" or the "Company") proposed changes to the Rules and Regulations; (b) RUCO Operating Adjustment Nos. 6 and 10 made by Mr. Moore; and (c) comments made by Ms. Scheier with respect to (1) the Company's efforts to enroll eligible customers in the Customer Assistance Residential Energy Support ("CARES") program; (2) the use of alternate locations to accept cash payments from customers; and (3) the increase in funding for community action agencies ("CAAs").

II. RESPONSE TO MS. DIAZ CORTEZ.

Q. At page 19 of her Surrebuttal Testimony, Ms. Diaz Cortez again takes issue with the Company's proposal to modify the billing time periods in its Rules and Regulations. Do you have any response?

A. Yes. Ms. Diaz Cortez criticizes my testimony on two grounds. First, she disagrees with my statement that the proposed billing timeframes are reasonable. What Ms. Diaz Cortez ignores is that the Arizona Corporation Commission ("Commission) Rules, particularly A.A.C. R14-2-310, are consistent with what the Company proposes. This fact is notably absent from Ms. Diaz Cortez's Surrebuttal Testimony.

Ms. Diaz Cortez then argues that the Company's response to her point that the Company is compensated for the billing lag is "irresponsible at best." Just because customers pay for the billing lag does not mean that it is good public policy to allow for extended payment periods. Taken to its logical conclusion, maybe Ms. Diaz Cortez would argue that the Company should allow a customer six months to pay his or her bill. This encourages poor payment practices and creates situations where multiple bills are due at the same time, making it more difficult for customers to stay current with their balances. Regardless, whether or not the Company is compensated through a billing lag does not address to whether or not the billing timeframe is reasonable or consistent with Commission Rules. The Company's modifications to the Rules and Regulations are appropriate. As stated in my Rebuttal Testimony, the Company will make the allowance that Staff requested for a six-month waiver for customers to become familiar and comfortable with this change.

III. RESPONSE TO MR. MOORE.

Q. In his Surrebuttal Testimony at pages 12 to 14 of his Surrebuttal Testimony, Mr. Moore again urges disallowance of what he argues are "inappropriate and/or unnecessary expenses." Do you have any response?

A. Mr. Moore has not addressed my Rebuttal Testimony on these expenses. While Mr. Moore suggests that the Company has only provided a "trust us and our process" response, I provided an extensive discussion on why these expenses were incurred. Again, review of the proposed disallowances reveals that most are directly related to safety, system integrity and operator training; thus, the expenses are clearly both appropriate and necessary. Mr. Moore makes no effort whatsoever to respond to my explanation of how and why these expenses were incurred, but rather makes a simple list of things he feels are unnecessary, even though these expenses were: (1) incurred performing regulatory-mandated functions such as leak surveys, safety audits, and training; (2) spent on communications in support of all our field communication equipment, and for lease of radio towers that are not only used for normal operations and maintenance but for public emergency situations as well; (3) used for materials, small tools, or personnel protective equipment; and (4) related to our Circle of Safety employee awareness program. My Rebuttal Testimony provides additional details on these expenses.

We continue to believe that these expenses are prudent, and RUCO has not demonstrated otherwise. However, given the small value of the items actually identified by RUCO, it makes little sense to spend further resources disputing these points. Therefore, the Company is proposing an adjustment of $ 27,968 to address the issue raised by RUCO.

Q. In his Surrebuttal Testimony at pages 15 to 16, Mr. Moore urges disallowance of union training as a one time, nonrecurring expense claiming as support a phone conversation he had with you. Do you have response?

A. Yes. As Mr. Dallas J. Dukes pointed out in his Rebuttal Testimony, while the M.A.R.C. Union Training was a one-time training event, training itself is certainly recurring. The Company is highly regulated, growing rapidly and continually adding new employees. Training is an on-going and primarily mandated process for the Company. Training costs will very likely continue to increase for the foreseeable future. In fact, since the end of the test year in this case, another regulatory mandated training program has been directed at all local distribution companies to provide training to both employees and the public. Removing any of these costs from the test year would not be appropriate.

IV. RESPONSE TO MS. SCHEIER.

Q. At page 2 of Ms. Scheier's Surrebuttal Testimony, she argues that the Company's efforts to enroll customers in the CARES program are inadequate. Do you have any response?

A. I am disappointed that Ms. Scheier chooses to be critical of the Company's efforts, especially in light of our increased outreach activities and agreement with her suggestion to automatically enroll LIHEAP recipients who are customers of record in the CARES program, assuming that the Company can acquire the necessary information. Staff recognized the improvement that the Company has made in expanding participation in the CARES program. As pointed out in my Rebuttal Testimony, we are committed to this program and strive to add households by distributing CARES applications to local assistance agencies, public libraries, and town and city halls within our service territory. We also insert CARES applications in all residential customers' bills every calendar quarter, (beginning in February of every year). As customers have discussions with the

Customer Call Center and indicate difficulty in making payments on their accounts, we provide them the information about and/or an application for the CARES program. While Ms. Scheier testifies that additional resources need to be allocated to support an effective outreach and enrollment program, she makes no specific recommendations as to how the Company might make its outreach program more effective, other than the automatic LIHEAP enrollment, which we have already agreed to do. Again, my door is always open to Ms. Scheier to work towards meaningful solutions concerning low income customers.

Q. At page 2 of her Surrebuttal Testimony, Ms. Scheier clarifies that ACAA is concerned that UNS Gas is referring customers to predatory lenders as an option for paying their bills. Do you have any response?

A. I appreciate Ms. Scheier's clarification that ACAA does not suggest that the Company is somehow encouraging customers to enter into agreements with pay day loan operations. We are certainly not. However, as discussed in my Rebuttal Testimony, customers could make the decision to enter into these agreements even if UNS Gas retained all of its branch offices and the customer needed cash to pay his or her gas bill, or even if there were "ATM-like Kiosks" as Ms. Scheier suggests. I am concerned about Ms. Scheier's testimony that low-income clients have reported that upon presenting their bill for payment at pay day loan facilities, customers have been encouraged to take out a loan. This is inconsistent with reports I have received from location managers. I encourage Ms. Scheier to provide the Company with specific information when she receives it so that the Company can inquire at the particular locations.

Again, UNS Gas is trying to keep costs down for all of its customers, including those low-income customers for which Ms. Scheier testifies, while maintaining local payment options for those customers who would like to pay their bills in person.

Q. Finally, at pages 2 to 3 of Ms. Scheier's Surrebuttal Testimony, she takes issue with your statement that CAAs need time to ramp up to support additional funding and the Company commits to work with CAAs prior to its next rate case to discuss opportunities. Do you have any response?

A. As shown in the Company's filing, the Company also proposes an increase in LIW funds in this proceeding. Perhaps what would be most helpful is if Ms. Scheier would provide to the Company and the Commission a breakdown of the funds the CAAs are currently using and what efforts they can support. Then the Commission can make an informed decision about just what increase is appropriate for the LIW program. I would certainly not advocate needy families being "put on hold," as Ms. Scheier suggests but the CAAs have the most relevant information to show the Commission concerning what funds they can effectively utilize.

V. RESPONSE TO MR. MAGRUDER.

Q. In his Surrebuttal Testimony at pages 27 to 31, Mr. Magruder makes several comments with regard to the Company's proposed changes to its Rules and Regulations. Would you please respond?

A. First, Mr. Magruder adopts the criticisms of RUCO and ACAA regarding the changes to the billing timeframe. Contrary to Mr. Magruder's suggestion, the proposed billing timeframe is both reasonable and consistent with Commission Rules. Again, under the Company's proposed rule, customers receive bills approximately two days after a billing period ends. A customer has 10 days to pay before a bill is considered late. Under the proposed changes, after that 10 day period, a customer has another 15 days before a late fee is assessed, for a total of 25 days since the bill was received. Only then would a bill be considered delinquent. The Company would not commence suspension of service procedures unless it did not receive payment for a delinquent bill after five days. So, the

customer has a total of 30 days after a bill receipt to pay his or her bill before a notice of shut-off is issued. This is entirely consistent with A.A.C. R14-2-310.C.

Mr. Magruder also disagrees with the Company's modification to Section 11.B.1.d. That modification made absolutely no substantive change to current practice, rather it clarified the Rules and Regulations language. The Company has always been permitted to terminate service without notice to comply with curtailment procedures during supply shortages. Such procedures are not only provided for, but are included in the Commission-mandated curtailment plan in the Company's pricing plans. This change simply refers to the pricing plans for the curtailment procedures.

In response to Mr. Magruder's specific recommendations:

(1) The Company believes that the Rules and Regulations, especially in their modified form, are reader-friendly, accurate and helpful to the customer.

(2) The Company has considered the impact of its changes. To that end, it has agreed with the Staff recommendation that a six-month waiver be implemented with regard to billing timeframe changes.

(3) Again, the proposed change to Section 11.B.1.d is not substantive and was made to make the Rules and Regulations easier to read and understand.

(4) With regard to the recommendation that a Spanish-version of the new Rules and Regulations also be approved by the Commission, the Company would be happy to translate the Rules and Regulations. As they will be the same as the English version, assuming the Commission approves the Rules and Regulations in this proceeding, further approval will not be necessary.

(5) With regard to Mr. Magruder's recommendation that all customers receive a copy of the new Rules and Regulations within 30 days of ACC approval or upon becoming a new customer, to do so would be extremely costly and such costs

would ultimately be borne by the ratepayer. The Rules and Regulations are available publicly on both the Company's and the Commission's websites.

Q. Does this conclude your Rejoinder Testimony?

A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MIKE GLEASON- CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASE GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

Rejoinder Testimony of

Denise A. Smith

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

I. Introduction 1

II. Response to Ms. McNeely-Kirwan 1

A. Baseline Study 1

B. Cost-Effectiveness Tests 2

C. DSM Adjustor Mechanism 3

D. DSM Reports 4

III. Response to Ms. Scheier 4

I. INTRODUCTION.

Q. Please state your name and address.

A. My name is Denise A. Smith. My business address is 4350 E. Irvington Road, Tucson, Arizona.

Q. Are you the same Denise Smith who filed Rebuttal Testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your Rejoinder Testimony in this proceeding?

A. The purpose of my Rejoinder Testimony is to respond to certain comments made in the Surrebuttal Testimonies of Ms. Julie McNeely-Kirwan on behalf of Arizona Corporation Commission ("Commission") Staff regarding Demand Side Management ("DSM") and Ms. Miquelle Scheier on behalf of Arizona Community Action Association ("ACAA") regarding the marketing of the Low Income Weatherization ("LIW") Program.

II. RESPONSE TO MS. MCNEELY-KIRWAN.

A. Baseline Study.

Q. In her Surrebuttal Testimony at pages 1 to 2, Ms. McNeely-Kirwan agrees with the concept of a baseline study and the recovery of the study through the DSM Adjustor Mechanism but testifies that the cost of the baseline study should not be included in the DSM Adjustor immediately. Do you have any response?

A. Ms. McNeely-Kirwan indicates that, at the time she was drafting her Surrebuttal Testimony, she did not have UNS Gas, Inc.'s ("UNS Gas" or the "Company") response to her data request concerning the costs of the baseline study. We have since provided that

information to Staff. As we explained in the response to JMK 23-1, the need for a baseline study is not limited to the UNS Gas service territory. UniSource Energy Corporation recognizes that conducting one study to cover the needs for UNS Gas, UNS Electric, Inc. and Tucson Electric Power Company provides efficiencies. The total estimated cost for a statewide baseline study was $370,000. A proportionate amount was assigned to each utility based on the percentage of customers in each service territory to the total number of customers served in the state. This baseline study includes reviewing existing data, model specifications, and data collection with field audits and inspections. This level of funding includes minimal metering and measurement activity. The resulting estimated proportionate cost for a baseline study for UNS Gas is $82,000. With this information, UNS Gas proposes that the baseline study be approved in this docket and recovered through the DSM Adjustor Mechanism.

B. <u>Cost-Effectiveness Tests</u>.

Q. In her Surrebuttal Testimony at page 7, lines 3 to 8, Ms. McNeely-Kirwan testifies that, while she does not disagree with the Company's internal use of other cost-effectiveness tests, the Commission Staff only utilizes the Societal Cost Test to evaluate the cost-effectiveness of DSM programs. Do you have any response?

A. Yes, I have two comments. First, I want to point out that the Company did provide the Commission Staff with information it requested on the Societal Cost Test. Second, I want to clarify that the Company believes that the other cost-effectiveness tests are not only important for the Company's internal review, but also to provide the Commission with a full and complete analysis of the DSM programs. Each test provides different information that may be considered in determining whether or not a DSM measure is right for UNS Gas' ratepayers. While the Company appreciates and supports Staff's DSM cost-effectiveness preference, it is UNS Gas' hope that the Commission might look

at each of the tests when considering DSM programs.

Q. In her Surrebuttal Testimony at page 7, lines 12 to 14, Ms. McNeely-Kirwan states that cost-effective DSM is less expensive than acquiring energy supplies. Do you have any response?

A. Yes, only to say that "cost-effective" is the operative word. The Company believes that DSM is only less expense when it is cost-effective under all of the DSM cost-effectiveness tests, especially the Rate Impact Measure test which shows the impact on all customers' rates that will result from adoption of a DSM measure.

C. <u>DSM Adjustor Mechanism</u>.

Q. In order to balance the need to avoid over-collecting and the Company's need to recover costs on a timely basis, Ms. McNeely-Kirwan proposes that the DSM Adjustor Mechanism initially include the LIW funding and one quarter of the proposed budget for the remaining DSM programs. Is this position acceptable to the Company?

A. While the Company believes that its proposal to initially recover LIW and 50% of the proposed budget for remaining DSM programs, it is willing to accept recover of LIW and 25% of the proposed budget, as Ms. McNeely-Kirwan recommends. In addition, because Ms. McNeely-Kirwan agrees with the approval of a baseline study and the inclusion of its cost in the DSM Adjustor Mechanism, the $82,000 cost associated with that baseline study (as discussed above), should also be included. This would change the adjustor recommended by Ms. McNeely-Kirwan slightly to $0.0031. This is accomplished by adding the LIW funding of $113,400 plus 25% of the proposed budget for the remaining DSM programs ($230,000) plus the $82,000 for the baseline study divided by the test year therms of 138,223,864.

D. DSM Reports.

Q. Ms. McNeely-Kirwan disagrees, on pages 9 to 10 of her Surrebuttal Testimony, with the Company's recommendation to move to annual DSM reporting. Do you have any response?

A. I understand Ms. McNeely-Kirwan's point about the Company proposing many new programs and the need to track those programs in their infancy. I also appreciate her suggestion that the question of moving to annual reports could be revisited once the programs have been established and are meeting goals in a cost-effective manner. The Company will therefore continue to report on a semi-annual basis on the dates recommended by Ms. McNeely-Kirwan until its programs are established, at which time, it will approach the Commission to reconsider moving to annual reporting. I note that the dates proposed by Ms. McNeely-Kirwan are acceptable to the Company so long as the Commission understands that some financial data may not be final. This is due to the fact that financial books often do not close until after the March date.

IV. RESPONSE TO MS. SCHEIER.

Q. On page 3 of her Surrebuttal Testimony, Ms. Scheier argues that if the Community Action Agencies ("CAAs") were provided funding to conduct meaningful marketing and if UNS Gas was involved in the marketing of the LIW program, more families could be served and there would be increased awareness. Do you have any response?

A. UNS Gas will ensure that information regarding the LIW program is placed on its website so that customers know of its availability. Again, UNS Gas has proposed an increase in LIW funding in this proceeding. The Commission certainly has the discretion to instruct UNS Gas to spend a greater percentage of the LIW funds on marketing. Should the

Commission think it appropriate, UNS Gas would utilize a portion of the LIW funding to prepare a brochure for the CAAs or UNS Gas to use to market to customers.. In addition, the CAAs may also want to use a portion of the allocated funding to market the program if necessary. Some of the CAAs have experienced a backlog of potential LIW participants. Therefore, the decision on whether or not to promote and/or market the LIW programs – and to what extent to market those programs – should be left up to the CAAs depending upon their resources.

Q. Does this conclude your Rejoinder Testimony?

A. Yes.

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS
MIKE GLEASON- CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
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IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

Rejoinder Testimony of

D. Bentley Erdwurm

on Behalf of

UNS Gas, Inc.

April 11, 2007

TABLE OF CONTENTS

I. Introduction 1

II. Customer Adjustment/Annualization 1

III. Throughput Adjustment Mechanism 6

IV. Rate Design/Customer Charges 7

V. CARES Policy 9

VI. CARES Recovery 10

Exhibit

Exhibit DBE-5 Customer Cyclicality

I. INTRODUCTION.

Q. Please state your name and address.

A. My name is D. Bentley Erdwurm. My business address is One South Church Avenue, Tucson, Arizona 85701.

Q. Are you the same D. Bentley Erdwurm who filed Rebuttal Testimony in this proceeding?

A. Yes, I am.

Q. Mr. Erdwurm, have you reviewed the Surrebuttal Testimonies filed by the Commission Staff and Intervenors in this case?

A. Yes, I have.

Q. What is the purpose of your Rejoinder Testimony?

A. My Rejoinder Testimony responds to the Surrebuttal Testimonies of Steven W. Ruback, Ralph C. Smith, and Julie McNeely-Kirwan on behalf of the Arizona Corporation Commission, Utilities Division Staff ("Staff"), Marylee Diaz Cortez on behalf of the Residential Utility Consumer Office ("RUCO"), and Mr. Marshall Magruder, a customer.

II. CUSTOMER ADJUSTMENT / ANNUALIZATION.

Q. Mr. Ralph Smith in his Surrebuttal testimony at page 22, line 7 through page 23, line 4 states that you used a hypothetical in your Rebuttal Testimony that was not related to the circumstances faced by the Company. Please comment.

A. The sole purpose of this hypothetical was to show that customer adjustment methods other than the "traditional" approach have been proposed by utilities and approved by this

Commission. The hypothetical was not meant to match the specific circumstance arising for UNS Gas, which is cyclical growth attributable to the comings and goings of seasonal residents. However, both the cyclical and hypothetical growth are instances where the traditional method fails to generate consistently reliable results.

Under the traditional approach, one compares the customer counts in each month of the test year to the test year-end level of customers. Then one multiplies the additional customers attributable to each month by the average revenue per customer for each month to obtain the additional revenue attributable to the additional customers. This method works well when growth is steady and additional customers are similar in size to existing customers. The traditional approach starts breaking down when the assumptions are not met, and that is the case with cyclical growth as experienced by the Company.

My hypothetical involved a "huge" customer – a customer much larger than other customers in the class – who joins the system. The traditional approach is put aside in such a circumstance because it produces spurious results. When the Commission has approved non-traditional customer adjustments, larger commercial and industrial customers have often been involved. It is typical across utilities for the largest industrial or commercial customer classes to be composed of customers with significant variation in size. As mentioned, this composition is ill-suited for the traditional approach.

Q. Has the Commission ever accepted a customer adjustment based on the specific methodology you proposed in UNS Gas?

A. Not to my knowledge. But I believe that the method represents a substantial improvement for cyclical growth situations and should be adopted in this case.

Q. Mr. Ralph Smith states, in his Surrebuttal Testimony at page 24, lines 15 to 22, that a method should be "straight-forward" and "transparent" enough for other parties to follow the results. He does not think your method meets that criterion. Please comment.

A. The method I used is not as simple as the "traditional" approach. However, the monthly growth rate is calculated by the standard method where one is given the number of periods (in this case, months), beginning customers, and ending customers. It is a standard exponential growth model. The topic is mathematically simpler than regression models commonly used in forecasting. While most analysts, myself included, may need to sometimes check some formulas to apply the techniques, doing so is not overly burdensome. The benefit of an improved result justifies a little extra effort on the part of analysts preparing and reviewing customer adjustments.

Q. Mr. Ralph Smith claims that your approach uses percentage "growth factors" instead of customer bill counts. Moreover, he claims that the technique was difficult to follow in terms of verifying the percentages used, and appears to understate growth. Do you agree?

A. No. The growth factors are based on customer bill counts, so his claim that the approach is not based on customer bill counts is not correct. The percentages are based on the constant growth model that assumes beginning and ending results.

Q. In his Surrebuttal Testimony at page 23, line 6 through page 24, line 14, Mr. Ralph Smith states that you made a mistake when you said that "one cannot explain a negative adjustment – an adjustment that will increase customers' rates – on a growing system. Customers on a system with a positive growth trend in revenue, in customers, and in sales, should never pay more because of some negative customer adjustments calculated using a non-applicable traditional approach." Please comment.

A. Mr. Smith spoke at length on this topic. When I referred to a "negative" customer adjustment for a growing system, I was referring to the overall customer adjustment (*i.e.*, the sum of all class adjustments). I agree with Mr. Smith that some classes may have positive adjustments while others have negative adjustments. The fact that positive and negative adjustments can exist simultaneously for different classes is irrelevant to the discussion of whether the traditional approach or the Company approach is preferred.

My point was a simpler one. If a class has positive growth, the customer adjustment should be positive. If the adjustment for this growing class is negative, the analyst should *strongly* consider another approach. A negative adjustment here would effectively increase rates, even though the positive growth in the class supports decreased rates. A negative adjustment for a growing class is nonsense. My primary gripe with the traditional approach when applied to the commercial customers is that depending on when the test year starts, the traditional approach leads to negative customer adjustments on four occasions. Mr. Smith states that these alternate test years are irrelevant because they were not used. I disagree. There is a problem here. The failure of the traditional technique to give a reasonable result on four of twelve occasions shows a weakness in the method. Regardless of when the test year starts, the class is still growing, and the adjustment should be positive.

Q. Ms. Diaz Cortez claims that there is "hardly the extreme seasonality" in the customer count to justify moving away from the traditional approach. Please comment.

A. Exhibit DBE-5 shows otherwise. The Rate 20 Commercial customer count is shown in Exhibit DBE-5, Page 1. The 2004 and 2005 customer counts are graphed for the calendar year January through December. This is a textbook case of cyclicality; the annual shapes match. Total customers are shown on Page 2 of the DBE-5. Again, textbook cyclicality.

When Ms. Diaz Cortez states – on page 12, lines 17 to 23 in her Surrebuttal Testimony – that there are month over month decreases only in the months of April, May, and July, and that the decreases range between "9/100th" of a percent and "1/3rd" of a percent, she attempts to trivialize the cyclicality that is clearly demonstrated in the Exhibit DBE-5, Page 1.

What Ms. Diaz Cortez failed to mention is that the January through December 2005 commercial customer count data reflects annualized growth of around 1.4%, and equivalent monthly growth of around 0.12% (12/100th of a percent). Twelve one hundredths of a percent is in the same ballpark as the 9/100th of a percent Ms. Diaz-Cortez quotes. Relatively speaking, a decrease of 9/100th of a percent is substantial when compared to the monthly growth of 12/100th of a percent. The decrease of 1/3rd of a percent is the same as a decrease of 33/100th of a percent, which is substantially different from the monthly growth of 12/100th of a percent. So, Ms. Diaz Cortez's simple approach does not comport with the relevant data.

Q. Is your method of customer adjustment for a cyclical class the only workable approach?

A. No. However, the approach is preferable to the traditional approach. I am hopeful that the parties will have an opportunity to discuss workable alternatives for customer adjustments for classes with cyclical growth or other atypical characteristics.

III. THROUGHPUT ADJUSTMENT MECHANISM ("TAM").

Q. Staff witness Mr. Steven W. Ruback, at page 1, line 12 of his Surrebuttal Testimony claims that the Company's TAM will "seriously dilute" the incentive of the Company to control cost. Do you agree?

A. I disagree with Mr. Ruback's claim for reasons I discussed in my Rebuttal Testimony. Specifically, the TAM affects revenue. It does not compensate for income shortfalls due to cost discrepancies. If the Company fails to control cost, net income will fall. The Company seeks to maximize income, so a strong incentive to control cost remains.

Q. Mr. Ruback states in his Surrebuttal Testimony at page 2, lines 14 to 25, that you claimed that Southwest Gas Corporation's TAM adjustment was not denied by the Commission. Please comment.

A. I believe that Mr. Ruback knows that I am not disputing the rejection of Southwest Gas' TAM. My point was that the Commission left the door open for additional discussion of the concept.

IV. RATE DESIGN / CUSTOMER CHARGES.

Q. In his Surrebuttal Testimony at page 4, line 22 through page 5, line 19, Mr. Ruback agrees that gas distribution costs are fixed costs and that are largely supported by volumetric rates. But he goes on to say that you "fail to understand that, according to rate design practice that fixed costs do not have to be recovered with fixed charges." Please comment.

A. I am well aware that fixed costs can be recovered through volumetric rates. In fact, the Company's own proportional responsibility allocation method is based on volumetric data. The Company's distribution fixed costs are primarily allocated to classes based on this proportional responsibility data. The result is that the distribution unit costs by class (in $/therm) are brought closer together.

Rate design determines how revenue is recovered from customers within a class. The recovery of more fixed cost though fixed charges (customer charges) is the Company's rate design goal. This helps eliminate the subsidy of low-use warm weather customers by high-use customers. The Company seeks to rectify a problem: Flagstaff customers are paying too much relative to warm weather customers. The Company is unconcerned with practices used in other jurisdictions when the application to our system results in gross geographical inequities. The Company's higher customer charges are an appropriate means of matching revenue to costs within a class.

Q. In her Surrebuttal Testimony, Ms. Diaz-Cortez of RUCO states on page 17, line 2 that low-use customers will see higher percentage increase in bills than high-use customers. She sees that as a negative in the Company's Rate design. Is there a problem with the Company's proposed rate design in this regard?

A. No. Customer charge increases will result in larger percentage increases for low-use

customers. This is a result of fixing a geographical inequity. Ms. Diaz-Cortez should keep in mind that customers tend to be "high-use" on the UNS Gas system because they live in colder climate zones. There are significant differences in climate on the system. It is unfair to view the high-use customer as necessarily wasteful or unconcerned about conservation. Similarly, many low-use customers may be unconcerned about conservation. A Flagstaff customer struggling to conserve may still use twice as much gas as a low-use customer. Also, low-income customers are not necessarily low-use customers as they may occupy sub-standard housing. In light of the above, the "fairest" approach to rate design is to tie it to cost causation. That is what the Company has done in its proposal. On the UNS Gas system, it is not so easy to identify the conservation conscious customers. Therefore, lowering the customer charges will not necessarily reward the conservation conscious.

Q. In his Surrebuttal Testimony, Mr. Marshall Magruder states on line 28, page 15 that the Company transferred some of "the "volumetric" charges from the cost of gas" to the customer charge. Do you agree?

A. No. No charges related to the cost of gas were transferred to the customer charge.

Q. In his Surrebuttal Testimony, Mr. Marshall Magruder states on line 19, page 15 that the Company's proposed rate design rewards high users by penalizing low users. Do you agree?

A. No. Currently, low-use customers are being subsidized. Customers in colder climates like Flagstaff are paying more than their fair share. The Company's proposal merely helps eliminate this inequity. The Company could have justified even higher customer charges, but moderated them in the interest of "gradualism."

Q. In his Surrebuttal Testimony, Mr. Marshall Magruder on line 13, page 22 has a title that reads "Gas Usage Charged with TAM When Not Using Gas." Please comment.

A. The title is wrong. Customers are never charged gas costs under the TAM.

Q. In his Surrebuttal Testimony, Mr. Ruback states on page 5, line 22 that he takes "umbrage with [Mr. Erdwurm's] comment that Staff did not consider cost of service principles in arriving at a recommendation." Please comment.

A. I did not mean to imply that the Staff did not do a thorough job. I know based on Staff testimony that the rates were extensively reviewed. The problem is that Staff is so concerned about "rate shock" and "gradualism" that substantial changes in rates are almost impossible to implement, even when socially desirable. Subsidies are perpetuated and inequities compounded. The process is frustrating because substantial work is completed, but few changes affecting customers are implemented.

V. <u>CARES POLICY</u>.

Q. Staff witness Julie McNeely-Kirwan states that the Company's CARES proposal lessens the incentive to conserve. Do you agree?

A. No. CARES customers all receive the same CARES discount under the Company's proposal. There is no need to use more gas to increase CARES benefits. That design is as pro-conservation as possible. The Company disagrees with Ms. McNeely-Kirwan's proposal to exempt CARES customer from general rate design provisions, as she advocates for in her Surrebuttal Testimony starting at page 3, line 18. The Company's design is based on cost and designed to eliminate geographic inequities.

VI. CARES RECOVERY.

Q. Do you have a concern about the Company's ability to recover of the cost of CARES based on the rate calculations in the in Mr. Ralph Smith's Surrebuttal Testimony at Attachment RCS-S1R, Schedule RD-1, Page 2 of 2?

A. Yes. Attachment RCS-S1R, Schedule RD-1, Page 2 of 2, shows Mr. Smith's proposed rates and the resulting revenue calculation. The Company's concern is that the distribution rate per therm is shown at the same level – $0.3177 per therm – for both Rate 10 (the regular residential rate) and for Rate 12 (the CARES residential rate.) However, a portion of the Rate 12 therms will be sold at a discounted rate under the Staff's proposal. Mr. Smith's calculation of the impact of those discounts is shown on Attachment RCS-S1R, Schedule RD-2. Under Staff's CARES proposal, the Company will collect less per therm under the distribution rate for Rate 12 than for Rate 10. Mr. Smith has made no upward adjustment to the total revenue requirement target that would recognize the absence of a stated discount; therefore Rate 12 must be adjusted downward to reflect the anticipated revenues to be collected based on Staff's proposed rate structure including their proposed CARES discount.

Q. Please explain your last statement about adjusting the revenue requirement to recognize the absence of a stated discount.

A. One may state the Rate 12 rates at the full Rate 10 levels and not show the rate discount in the proof of revenue. However, the revenue requirement would accordingly need to be increased to reflect the recovery of the CARES discount as an expense. To correct Mr. Smith's attachment, one would increase the total revenue requirement by $320,006.

Q. Did the Company show rate components without a discount, and recognize this in the revenue requirement?

A. Yes. The Company booked the discount as revenues, and recorded an equivalent expense. There is no impact on operating income.

Q. Did Mr. Smith recognize the discount with his ($320,006) entry on line 5, column F of his attachment?

A. This number stands alone in column F, but does not appear to be used in any calculation. Column F would also been an appropriate place to show the revenue increases by class that would cover the CARES cost. All the non-CARES revenue increases would total to positive $320,006, exactly offsetting the negative CARES discount of ($320,006). So, Column F would net to zero.

Q. How should this issue be handled?

A. The Company hopes that Mr. Smith's failure to provide recovery for CARES was an inadvertent error. If this is the case, the Company would appreciate revisions to his schedule at the earliest opportunity.

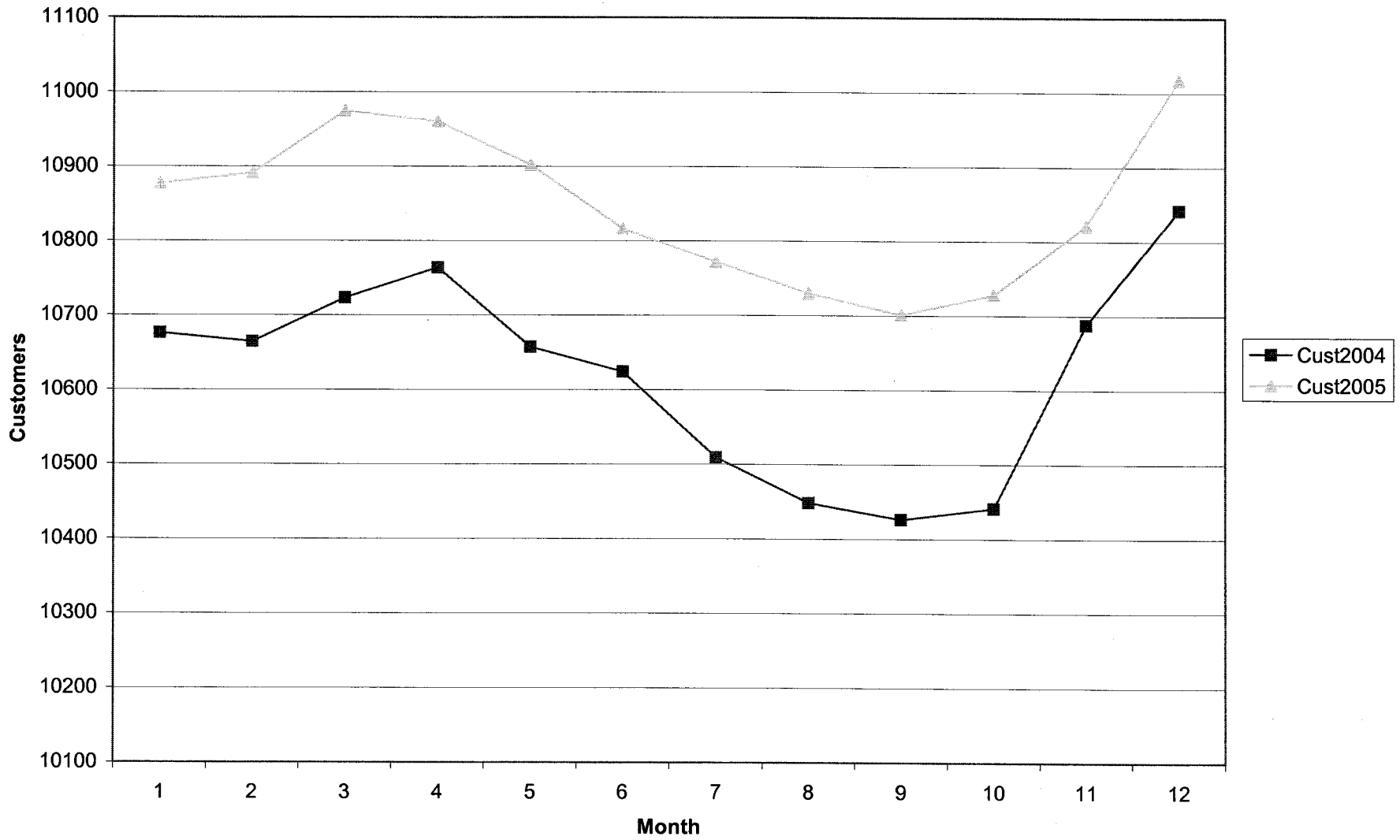
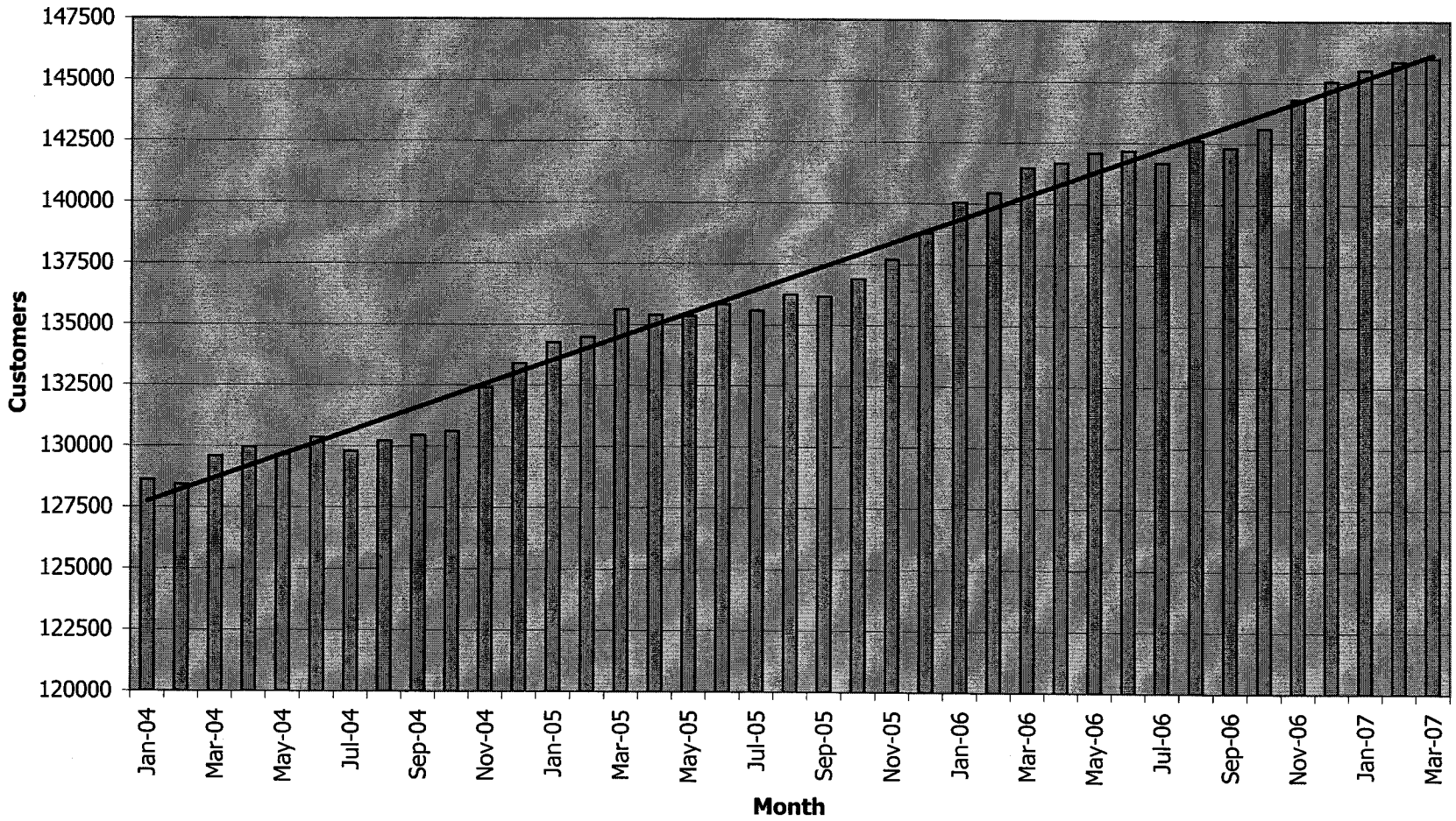
Q. Does this conclude your Rejoinder Testimony?

A. Yes.

EXHIBIT

DBE-5

Cyclicality in Commercial Customers



Cyclicality in Total Customers